

Chapter 2 the one lesson of business

Government, Capitalism



Chapter 2 The One Lesson of Business Chapter 2 — Summary of main points

- Voluntary transactions create wealth by moving assets from lower to higher-valued uses. - Anything that impedes the movement of assets to higher-valued uses, like taxes, subsidies, or price controls, destroys wealth. -

Economic analysis is useful to business for identifying assets in lower-valued uses. - The art of business consists of identifying assets in low-valued uses

and devising ways to profitably move them to higher-valued ones. - A

company can be thought of as a series of transactions. A well-designed

organization rewards employees who identify and consummate profitable

transactions or who stop unprofitable ones. 3 Introductory anecdote - Two prominent hospitals recently refused patients for kidney transplants because

the organs were from “directed donations.” - Demand for organs is high —

far exceeding supply - and many never receive them. - Despite high demand

and low supply, buying and selling organs is illegal. - Why? 1 Capitalism 101

To identify, you must first understand how wealth is created (and

sometimes destroyed). - Definition: Wealth is created when assets are

moved from to uses - Definition: Value = - + . 4 . - The chief virtue of a

capitalist economy is its ability to create wealth - create wealth. , between

individuals or firms, 5 Example: Robinson Crusoe economy - A house is for

sale: - The buyer values the house at \$130,000 — - The seller values the

house at \$120,000 — . . - The buyer and seller must agree to a price that “

splits” surplus between buyer and seller. Here, \$128,000. - The buyer and

seller both benefit from this transaction: - Buyer surplus = - Seller surplus = -

Total surplus = = difference in values 6 Wealth-Creating transactions - Which

assets do these transactions move to higher-valued uses? - Factory Owners -

Real Estate Agents - Investment Bankers - Corporate Raiders - Insurance Salesman - Discussion: How does eBay create wealth? - Discussion: Which individual has created the most wealth during your lifetime? - Discussion: How do you create wealth? 2 Do mergers create wealth? - The movement of assets to a higher-valued use is the wealthcreating engine of capitalism. - Our largest and most valuable assets are . 7 - Dell-Alienware merger: - In 2006, Dell purchased Alienware, a manufacturer of high-end gaming computers. - Dell left design, marketing, sales and support in Alienware's hands; manufacturing, however, was taken over by Dell. - With its manufacturing expertise, Dell was able to build Alienware's computers at a much lower cost - Despite this example, many mergers and acquisitions do not create value — and if they do, value creation is rarely so clear. - To create value, the assets of the acquired firm must be . 8 Does government create wealth? - Discussion: What's the government's role is wealth creation? - Discussion: Why are some countries so poor? - No , no - Discussion: Much of the justification for government intervention comes from the assertion that markets have failed. One money manager scoffed at this idea. " The markets are working fine, but they're giving people answers that they don't like, so people cry market failure. " 9 The one lesson of economics - Definition: an economy is efficient if . - This is an unattainable, but useful benchmark - The One Lesson of Economics: the art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups. - Policies should then be judged by whether they move us towards or away from efficiency. - The economist's solution to

inefficient outcomes is to argue for a change in public policy. 3 10 One lesson of economics (cont.) - Taxes Destroy Wealth: - By deterring wealth-creating transactions — when . - Which assets end up in lower-valued uses? - Destroy Wealth: - Example: flood insurance — encourages people to build in areas that they otherwise wouldn't - Which assets end up in lower-valued uses? - Destroy Wealth: - Example: rent control () in New York City - deters transactions between owners and renters - Which assets end up in lower-valued uses? 11 The one lesson of business - Definition: Inefficiency implies the existence of unconsummated, wealth-creating transactions - The One Lesson of Business: the art of business consists of identifying assets in lower valued uses, and profitably moving them to higher valued uses. - In other words, make money by identifying unconsummated wealth-creating transactions and devise ways to profitably consummate them. 12 The one lesson of business (cont.) - Taxes create a profit opportunity - Discussion: 1983 Sweden tax - Subsidies create opportunity - Discussion: health insurance - Price-controls create opportunity - Discussion: Regulation Q. & euro dollars - Discussion: What about ethics? 4 13 Companies create wealth - Companies are collections of transactions: - They go from buying raw materials, capital, and labor () - To selling finished goods & services () - Why do some companies have difficulty creating wealth? - They have trouble moving assets to higher-valued uses - Analogy to taxes, subsidies, price controls on internal transactions 14 Alternate intro anecdote - Zimbabwe experienced economic contraction of approximately 30 percent per year from 1999 to 2003 - Unemployment rates have been as high as 80 percent and life expectancy has fallen over 20 years during the reign of Robert

Mugabe - Why has economic growth been so low? Alternate intro anecdote (cont.) - One main problem occurred in 2000 - Mugabe backed his supporters takeover of commercial farms, essentially revoking property rights of these farmers - The state resettled the confiscated lands with subsistence producers - many with no previous farming experience. Agricultural production plummeted. - Farm debacle had economic ripple effects through the banking and manufacturing sectors - Declining production deprived the country of ability to earn foreign currency and buy food overseas - Widespread famine ensued - The government's initial attack on private property eventually led to more direct intervention in the economy and the destruction of political freedom in Zimbabwe. 15 5