

CHAPTER 2

The Power of Markets and the Wealth of Nations

CHAPTER SUMMARY AND TEACHING OBJECTIVES

It is important to understand the underlying fundamentals associated with economic success. One finds property rights, the freedom to trade, incentives, and the freedom to choose. It will be seen that these fundamentals are also part of successful management and successful businesses. It is important for individuals to have incentives to better themselves. Markets, trade and prices guide people toward a higher level of economic wellbeing.

IMPORTANT TERMS

Property Rights people own things and can do with them pretty much as they wish and they can exclude others from using the things they own

Absolute Advantage this occurs if a country can simply produce the most of any one good

Comparative Advantage this occurs when a country is relatively more efficient at producing a product

Gains from trade this occurs when everyone does what they can do at the least cost and then trades

Scarce everyone cannot acquire all that they want

Efficient can produce a given quantity of a product at the lowest possible cost

Opportunity Costs what must be given up to acquire a product

Arbitrage the buying of identical products and the selling them in another market for a higher price

Monopoly a single seller or a unique place in a market

Brand name a form of monopoly – a market niche where competition is limited

TOPICS AND TEACHING SUGGESTIONS

1. Why Are Some Countries Rich and Others Dirt Poor

The most fundamental component to the wealth of a country is the presence of property rights. Property rights help create positive incentives for wealth creation. Free trade based on comparative advantage has the same effect.

2. Efficiency

A system of markets and prices is the most efficient arrangement for coordinating and organizing activities. The use of a price system creates incentive for growth and wealth creation. All other allocation schemes fall short of attaining a level of efficiency compared to that created by the price system.

ANSWERS TO EXERCISES

1. What are “gains from trade”? What is the primary benefit of trade? Why is the idea that trade is beneficial counter-intuitive?

Gains from trade are the result of having everyone do what are the least cost and then trade. It will take less to get everything. In essence everyone's income rises. This increase in income is the primary benefit of trade. For some it seems like doing everything is best. Trade and specialization creates interdependence that, for some, is not a good thing.

2. What is the difference between “absolute advantage” and “comparative advantage”? How can a less developed country like Mexico have a comparative advantage relative to the US?

Absolute advantage is based on total productivity. Comparative advantage is based on relative productivity. Mexico has a comparative advantage if it gives up less of an amount something per unit of another product compared to the United States. Poor countries may have lower total productivity but this does not mean that they don't have a relative advantage in doing something.

3. What is the difference between rich and poor nations? How did they become rich or poor?

The difference is found in the fundamental framework of their respective economic systems. Property rights are a key to economic wealth. This focuses economic activity on individual decision-making. Incentives are created that promote efficiency. All nations start out poor. What matters is how they use their national endowments and if they trade with others.

4. It has been argued that climate is a predominant explanatory variable in income distribution in the sense that nations along the equator are poor while those in cooler climates are rich. Can you explain why this might make sense?

Climate may simply be the luck of the draw. What matters is whether or not property rights are a fundamental component of their economies. One could argue, wrongly, that a continually warm climate makes their economies dependent on agriculture and not manufacturing.

5. Another argument is that the dominance of Catholicism explains economic development. A third argument is that the form of colonialism is what matters. Try to explain these positions using private property rights.

If property rights matter, then it also matter whose property is it. In both of these arguments, individuals do not own the property. Property rights matter if they are found in individuals.

6. Why might a policy that simply forgives \$40 billion of debt not benefit those nations whose debt is forgiven? Would this policy and the incentives created say anything about the policy response to the “subprime mortgage” crisis experienced in the US in 2007 and 2008; the government enacted legislation “forgiving” the debt of some debtors.

Forgiving people for prior bad acts creates a moral hazard. It will encourage people to do the same bad act again with the knowledge that it was forgiven in the past. Economic systems based on property rights found in individuals also have individual responsibility as a component.

7. What are private property rights? Why are private property rights necessary for markets to function?

Property rights represent the power to use something as you see fit as long as it does not harm others. The value stemming from the use of the property goes to the owner of it. This places incentives clear on the individual. Individuals bare all the benefits and costs from using the property. This structure is necessary for the functioning of markets.

8. Hernando de Soto (a Bolivian economist) argues that property rights are even more important in the developing world than in rich nations. What is his argument? How could the absence of well-defined property rights affect economic development? What might the absence of well-defined property rights mean for illegal immigration? DeSoto has argued that the LDCs fail to grow primarily because of a lack of private property rights. How does that analysis apply to the Native American?

DeSoto's argument is that poor people cannot access capital to invest without collateral. The establishment of private property rights also establishes ownership. Things that are owned can serve as collateral. In both cases, illegal immigrants and native Americans lack necessary property rights and, as such, cannot access the capital needed for growth.

9. What does the following statement mean? "Indeed, every decision we make involves some kind of trade-off." Under what condition would the statement not be true?

Scarcity forces people to make choices. If something is selected, something else must be given up. This is the nature of a tradeoff. A free good is something you can get without giving up anything to get it – there is no tradeoff.

10. It has been said that "Prices are like giant neon billboards that flash important information." Describe the types of information that market prices provide.

Prices signal value. They tell a consumer a dollar representation of what must be given up to get something else. Prices also communicate value to firms in the form of revenue. Prices also represent an incentive system. Prices are signals as individuals operate in a setting of scarcity.

11. In this and the last chapter it was noted that "Profit opportunities attract firms like sharks to blood..." Explain

Entrepreneurs are always looking for profitable opportunities. Profits signal value. By creating something society values, entrepreneurs profit. Profits encourage duplication. As will be seen in future chapters, profits must be abnormal.

12. "The problem with Asian sweatshops is that there are not enough of them." -- Charles Wheelan, *Naked Economics*, p. 20. How is Wheelan's statement illustrative of the concept that every market transaction makes all parties better off?

Sweatshops use labor to assemble clothing. The sweatshop owner benefits by creating clothing that can be sold and the workers receive a wage. Both parties benefit. However, 'sweatshop' has a bad connotation associated with exploitation. If there were more of them, their owners would have to compete more for workers and the workers would benefit.

13. What incentives are created by each of the following allocation mechanisms? Market, first come first served, government.

A first come first serve creates an incentive to get in the front of the line. Government creates an incentive to be favored by the government. Markets allocate based on income and the ability to pay. It creates an incentive to earn more income. As a result, individuals engage in activities that will make them richer – clearly making them better off.

14. Why does market allocation lead to an increased supply whenever a shortage situation exists?

With a shortage, buyers of a product bid price up. This is to say, they communicate increasing value to sellers. This creates an incentive for sellers to bring more to the market.

15. The following data represent the production possibilities of two people in solving math and economics problems. If they devote their total effort and time to math, A can solve 10 math problems and B can solve 10 math problems. If they devote their total effort and time to economics, A can solve 10 economics problems and B 5 economics problems.

Percent of Resources Devoted to:		A		B	
<u>Math</u>	<u>Economics</u>	<u>Math</u>	<u>Economics</u>	<u>Math</u>	<u>Economics</u>
100	0	10	0	10	0
0	100	0	10	0	5

- Who has the absolute advantage? *A has an absolute advantage in economics problems*
- Who has the comparative advantage? *A also gives up 1 math problem to solve an economics problem. B has an opportunity cost of 2 math problems for every economics problems. So B should specialize in math problems*
- Assume that each will be self-sufficient and devote half their resources to math and half to economics. The outcome follows.

	A	A	B	B
Alone – no trade	Math	Economics	Math	Economics
	5	5	5	2.5

A B

Now assume they specialize according to comparative advantage. How much math and economics will they produce together? What are the gains from trade? *A specializes in economics problems while B specializes in math problems. In the end, 10 math problems are solved and 10 economics problems are solved. The gains from trade are seen in the 2.5 additional economics problems are solved.*