Session One

Purpose, Liberty, Property, & Labor

Thinking Economically

Thinking Economically

Overview

- Session 1: Purpose, Liberty, Property, and Labor
  - Worldviews
  - Human action
  - Praxeology and Economics
  - Life, Liberty, and the Pursuit of Happiness
  - Property
  - Consumer Choice or Protection?
- Session 2: Capital and Abundance
  - Entrepreneurship
  - Production: The Basics
  - Innovation and Growth: Lengthening the Production Process

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Purpose: Worldviews

- Are there universal truths? Or is everything subjective?
- What is a worldview?
  - A "framework of assumptions about the world."
- What are some examples of worldviews?
  - secularism, hedonism, humanism, existentialism, pragmatism, relativism, pluralism, deism, Hinduism, Islam, and Christianity
- Agree or disagree: "Everyone has a worldview. Whether or not we realize it, we all have certain presuppositions and biases that affect the way we view all of life and reality."
- What is the reasonable man standard? How does it differ from the worldview standard? Why did Bill Nye and Ken Ham talk past each other?

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Purpose: Human Action

- Human action is purposeful action.
- What is the purpose of human action?
- Do people ALWAYS act in their own best interest? Or in what they believe to be their own best interest?
- "You, being a rational person, will always choose what seems to you to be the right thing, the wise thing, the advisable thing to do. … Our choices … are determined by influences and considerations which we find attractive and compulsive, as the case may be."

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Purpose: Praxeology and Economics

- Science is the study of those things having, or appearing to have, an exact, objective, factual, systematic, or methodological basis.
- Where did this order come from?
- Economics as a science: economic laws are immutable because there is a predictable regularity to the interaction of people in society. But how do we know what they are? A priori v. a posteriori.
- Economics as an art. How does human action differentiate economics from other sciences?

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Liberty: Life, Liberty, and the Pursuit of Happiness

- What is the purpose of government?
  - "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. — That *to secure these rights, Governments are instituted among Men*, deriving their just powers from the consent of the governed." – Declaration of Independence
  - "He has sent me to proclaim liberty to the captives and recovering of sight to the blind, to set at liberty those who are oppressed." Luke 4:18
  - *The purpose of government, and the magistrate, is to* "uphold God's glory, to preserve the divine truth, and to ensure the continuance of the Kingdom of Christ" – John Calvin
  - Hobbes and Locke got it wrong: "that a man be willing, when others are so too, as far-forth as for peace and defence of himself he shall think it necessary, to lay down this right to all things, and be contented with so much liberty against other men as he would allow other men against himself." – Thomas Hobbes, Chap. XIV, ***Leviathan***

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Property: Ownership of Private Property

- The fundamental economic issue is ownership of private property
- Two Paths: In a world of scarcity, how do we live "without our starving to death or killing one another in a barbaric struggle for survival?"
- Path of Abundance: Production and Exchange (including Charity); this way presupposes private property
- Path of Poverty: Theft, Slavery, and Murder; this way also presupposes private property
- One can't be a steward of someone else's property: Efforts to do so, i.e., taxation, regulation, and condemnation, reduce prosperity and corrupt morality
- Questions of public policy are not ultimately questions of utility, they are questions of morality and ethics: Does a policy promote liberty or theft?
- "Property owners do not acquire a constitutionally protected vested right in property uses." – Texas Supreme Court; City of University Park v. Benners, 485 SW 2d 773 (1972)

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Labor: Consumer Choice or Protection?

- Markets or Governments?
  - "Regulation displaces competition. Displacement is the purpose, indeed the definition, of regulation. Limitations on the number of taxicabs, licensing of barbers and dentists, health and safety codes, zoning laws, and price supports for milk depend on a belief that competitive markets should be replaced with something else." – Frank Easterbrook, "Antitrust and the Economics of Federalism."
- Value and voluntary exchange of property
- Market or government failure? Unfair prices, unsafe products and workplaces, market power, externalities, and monopolies

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Labor: People Failure

- Four areas of uncertainty
  - Quantity demanded
  - Price
  - Technological longevity
  - Competition
- What is the best way to overcome this uncertainty, to move us away from poverty toward abundance?
- Billions of people making value determinations though voluntary exchange? Or thousands/millions of people making decisions for the billions?

Purpose and Property

Economics and Human Action
Thinking Economically Session 1 Study Guide

Required Reading:
Violate at Your Own Risk: The Immutability of Economic Laws – Thinking Economically: Lesson 1 by Dr. Arthur B. Laffer.
Economics for Real People, by Gene Callahan, Chapter 1: What's Going On?
Economics in One Lesson, by Henry Hazlitt, Chap. 1, "The Lesson." (3 pages)
Bill Nye's Reasonable Man by Albert Mohler
On Worldviews by James Anderson
"The Importance of Institutions" and "Private Property," in *Government & Prosperity: Free Market Institutions* – *Thinking Economically: Lesson 3* by Dr. Arthur B. Laffer

Please use the readings above and the additional quotes/discussion questions below to prepare for our discussion on each of the topics.

Discussion Outline

I. Worldviews
   a. "Everyone has a worldview. Whether or not we realize it, we all have certain presuppositions and biases that affect the way we view all of life and reality. A worldview is like a set of lenses which taint our vision or alter the way we perceive the world around us. Our worldview is formed by our education, our upbringing, the culture we live in, the books we read, the media and movies we absorb, etc. For many people their worldview is simply something they have absorbed by osmosis from their surrounding cultural influences. They have never thought strategically about what they believe and wouldn't be able to give a rational defense of their beliefs to others." – Israel Wayne
   b. "Now the critic may feel that this skirts the issue. "Yes, yes," he says, "I believe that every thought is defined by our worldview, but I do not believe that 2 + 2 = 4 is part of the conflict between worldviews. What difference could it make who teaches neutral subjects like mathematics? 2 + 2 = 4 is true no matter what your perspective." Not quite. Even here the impossibility of neutrality can be clearly seen. How do we know that 2 + 2 = 4? Are we empiricists or rationalists? Are 2 and 4 mere linguistic conventions? Is our knowledge a priori or a posteriori? Do we remember this information from a previous life as Plato taught? Is there any epistemological foundation for mathematics? On a more practical level, should a teacher of young children drill them in their math tables, or should she simply seek to get them to understand the concept? Do these different teaching methodologies reflect differences in worldview? The answer is: they certainly do. At Logos, we require that the children memorize quite a bit of material, and that involves work — productive work with lasting value. We require this because of our view of work. I have seen one result of this type of hard work around our dinner table. My children can beat

me in answering questions like, “What is 8 times 7?” They have memorized their tables and I didn’t! They are receiving a much better education than I received. Their learning of math is built on a different foundation than mine was, and it shows. Those who think that neutrality in mathematics is possible need to think again. To be sure, some of these questions will not be raised explicitly when children are learning how to add or multiply. But this does not mean that certain answers to these questions are absent from the classroom.” – Douglas Wilson

c. “Worldviews are inescapable, and every tribe, nation, and people in the history of the world have always had them. But we started talking about it in the late 18th century. The first person to use the word (*Weltanschauung*) was the philosopher Immanuel Kant. But he simply meant “sense perception of the world.” But the word caught on, and almost immediately after this, other philosophers picked it up and began using it in a sense more familiar to us—meaning “framework of assumptions about the world.” Throughout the course of the nineteenth century, the idea was important to philosophers like Hegel, Kirkegaard, and Nietszche. But conservative Christians soon picked up the idea to advance the idea of a fully-orbed Christian take on the world. This was done by James Orr and Abraham Kuyper, carrying over into the early twentieth century. The most recent round of play was initiated by Francis Schaeffer in the 1970s.” – Douglas Wilson
d. “To Al Gore, the “planetary emergency” is five-to-six billion people using oil, gas, or coal for most of their energy needs. But the real energy problem is *that one-and-a-half billion people do not use modern forms of energy*.” – Robert Bradley.
e. “Regarding the Hockey Stick of IPCC 2001 evidence now indicates, in my view, that an IPCC Lead Author working with a small cohort of scientists, misrepresented the temperature record of the past 1000 years by (a) promoting his own result as the best estimate, (b) neglecting studies that contradicted his, and (c) amputating another’s result so as to eliminate conflicting data and limit any serious attempt to expose the real uncertainties of these data.” – John Christy
f. “*Schwerpunkt*, as German military theorists used to say with satisfaction, is the place where force is concentrated and applied; and what lies behind is a doctrinal system, a way of looking at the world, and so an ideology. It is an ideology with no truly distinct center and the fuzziest of boundaries. For purposes of propaganda it hardly matters. Science as an institution is unified by the lowest common denominator of belief, and that is the conviction that science is a very good thing.” – David Berlinski
g. Discussion Questions
    i. What is a worldview?
    ii. Do you have a worldview? What is it?
    iii. Discuss some worldviews such as secularism, hedonism, humanism, existentialism, pragmatism, and Christianity.
    iv. Are everyone’s beliefs influenced first and foremost by their worldview?
    v. How does one’s worldview effect the evaluation of facts? How can it help in seeking solutions to the policy problems we face today?
    vi. What point is Douglas Wilson making about worldviews? What do you think about his argument?
    vii. Is science objective? Are worldviews subjective?

viii. How is science being used today in debates about public policy and worldviews in general?
ix. Should science, be it a physical or social science, be the arbiter of what is true? If not, how do we know what is true?
x. Why is the concept of worldviews important in the discussion about the Ham v Nye debate?
xi. What is the "reasonable man" argument? How does is differ from the worldview concept?
xii. Consider their statements that neither Ham nor Nye would change his mind if given new facts in the light of worldviews. What does Moeller say differentiates their commitment to what they believe? Is either of their positions reasonable?
xiii. How could Al Gore and Robert Bradley have such diametrically opposing views? How could the Hockey Stick become the defining standard of climate change policy? What are the facts in this case? Who's right? How do you know?

II. Human Action
   a. Additional Quotes
      i. "Human action is purposeful behavior. Or we may say: Action is will put into operation and transformed into an agency, is aiming at ends and goals, is the ego's meaningful response to stimuli and to the conditions of its environment, is a person's conscious adjustment to the state of the universe that determines his life. Such paraphrases may clarify the definition given and prevent possible misinterpretations. But the definition itself is adequate and does not need complement of commentary." – Ludwig von Mises
      ii. "Action involves the expectation that purposeful behavior has the power to remove or at least alleviate uneasiness. It presupposes uncertainty about the future." – Barry Smith
      iii. "All men seek happiness. This is without exception. Whatever different means they employ, they all tend to this end. The cause of some going to war, and of others avoiding it, is the same desire in both, attended with different views. The will never takes the least step but to this object. This is the motive of every action of every man, even of those who hang themselves." – Blaise Pascal
      iv. "You, being a rational person, will always choose what seems to you to be the right thing, the wise thing, the advisable thing to do. … Our choices … are determined by influences and considerations which we find attractive and compulsive, as the case may be." – John Gerstner
      v. "The wellspring of human action is dissatisfaction, or, if you want to see the glass as half full, the idea that life might be better than it is at the present." – Gene Callahan
      vi. "One thing have I asked of the Lord, that will I seek after: that I may dwell in the house of the Lord all the days of my life, to gaze upon the beauty of the Lord and to inquire in his temple." – Psalm 27:4
      vii. The characteristic mark of ultimate ends is that they depend entirely on each individual's personal and subjective judgment, which cannot be examined,

measured, still less corrected by any other person. Each individual is the only and final arbiter in matters concerning his own satisfaction and happiness. As this fundamental cognition is often considered to be incompatible with the Christian doctrine, it may be proper to illustrate its truth by examples drawn from the early history of the Christian creed. The martyrs rejected what others considered supreme delights, in order to win salvation and eternal bliss. They did not heed their well-meaning fellows who exhorted them to save their lives by bowing to the statue of the divine emperor, but chose to die for their cause rather than to preserve their lives by forfeiting everlasting happiness in heaven. What arguments could a man bring forward who wanted to dissuade his fellow from martyrdom? He could try to undermine the spiritual foundations of his faith in the message of the Gospels and their interpretation by the Church. This would have been an attempt to shake the Christian's confidence in the efficacy of his religion as a means to attain salvation and bliss. If this failed, further argument could avail nothing, for what remained was the decision between two ultimate ends, the choice between eternal bliss and eternal damnation. Then martyrdom appeared the means to attain an end which in the martyr's opinion warranted supreme and everlasting happiness. – Ludwig von Mises, in the Introduction to *Theory and History*.

viii. "There's strong evidence that the prevalence of bad science and "cut corners" is increasing. University of Montreal's Daniele Fanelli examined over 5,000 published papers from around the world, and over many disciplines. His stunning 2012 finding was titled "Negative Results are Disappearing from Most Disciplines and Countries," and it documented a systematic increase in the frequency of "positive" findings being published. All the incentives push science in the direction of positive results, and there is every disincentive (such as loss of funding and therefore your job) to not report when your research hypothesis isn't borne out by the data. Fanelli also found, in separate work, that the addition of a single American author to a multi-authored international paper greatly raises the probability that it will report a positive result. All of this is tragic. In biomedicine, people suffer and die because of falsely promised cures. In climate change, we get poisonous policies emanating from absurd results generated by climate models that can't even get the last two decades right. And around the world, the quality of science is in decline as nations increasingly adopt our model for professional advancement." – Patrick Michaels.

b. Discussion Questions

i. What is human action?

ii. What is a reflexive action? A human, or purposeful, action? What is the difference?

iii. Why do people act?

iv. How does Ludwig von Mises define human action?

v. What are the similarities and differences between self-interest and selfishness? How does Mother Theresa help us think about this?

vi. Do you believe that people ALWAYS act in their own best interest?

vii. Do you believe that people ALWAYS act in what they believe to be their own best interest?
viii. How does human action also differentiate economics from other sciences, allowing us to also call economics an art?
ix. How does the Patrick Michael's quote relate to the discussion of human action?

III. Economics and Praxeology
  a. Definitions
    i. Gene Callahan – the science of human action
    ii. American Heritage – the social science that deals with the production, distribution, and consumption of goods and services (1969) and with the theory and management of economies or economic systems. (1992)
    iii. McConnel/Brue – the social science concerned with the efficient use of scarce resources to achieve the maximum satisfaction of economic wants.
    iv. Glencoe's Today and Tomorrow – the study of how individuals, families, businesses and societies use limited resources to fulfill their unlimited wants
    v. Vance Ginn - the study of human action and interaction to satisfy individual desires given scarce resources.
    vi. Bill Peacock - the study of human action, especially voluntary exchange, to satisfy human desires without violence in a world of scarcity
  b. Praxeology and Truth
    i. Ludwig von Mises on Praxeology, the general theory of human action: "Praxeology is a theoretical and systematic, not a historical, science. Its scope is human action as such, irrespective of all environmental, accidental, and individual circumstances of the concrete acts. Its cognition is purely formal and general without reference to the material content and the particular features of the actual case. It aims at knowledge valid for all instances in which the conditions exactly correspond to those implied in its assumptions and inferences. Its statements and propositions are not derived from experience. They are, like those of logic and mathematics, a priori. They are not subject to verification or falsification on the ground of experience and facts. They are both logically and temporally antecedent to any comprehension of historical facts. They are a necessary requirement of any intellectual grasp of historical events. Without them we should not be able to see in the course of events anything else than kaleidoscopic change and chaotic muddle. … History cannot teach us any general rule, principle, or law. There is no means to abstract from a historical experience a posteriori any theories or theorems concerning human conduct and policies. The data of history would be nothing but a clumsy accumulation of disconnected occurrences, a heap of confusion, if they could not be clarified, arranged, and interpreted by systematic praxeological knowledge."
    ii. "We can see this more clearly when we look at a syllogism that has no basis in reality, for instance: 'All unicorns have a single horn. If I see a unicorn in my yard today, it will have a single horn.' The syllogism is clearly true, even though no unicorns have ever existed, so that we could not possibly have any empirical facts about them. The question of why we can assert that the

propositions of geometry and logic are true has been the subject of much philosophical and theological debate. The principles of human action are similar in that, once we notice them, they appear self-evidently true, without it immediately being clear why that is so. But economics does not attempt to solve the riddle of why we think the way we do. To economics, this fact is an ultimate given." – Gene Callahan, Economics for Real People, 29

iii. Robert Murphy, [Lessons for the Young Economist]:

The important point is that the mathematician knows that the Pythagorean Theorem *is* true, because he can *prove it* using indisputable, step-by-step, logical deductions from the initial assumptions.

This is a good analogy for how we derive economic principles or laws. We start with some definitions and the assumption that there is a mind at work, and then we begin *logically deducing* further results. Once we have proved a particular economic principle or law, we can put it in our back pocket and use it in the future to help in proving a more difficult result. And if someone asks us whether the data "confirm or reject" our economic principle, we can respond that the question is nonsense. An apparent "falsification" of the economic law would really just mean that the initial assumptions weren't satisfied. For example, we will learn in Lesson 11 the Law of Demand, which states that "other things equal, a rise in price will lead to a drop in the quantity demanded of a product or service." Now if we try to "test" the Law of Demand, we will certainly be able to come up with historical episodes where the price of something rose, even though people bought more units of the good. This finding doesn't blow up the Law of Demand; the economist simply concludes, "Well, 'other things' must not have been equal."

iv.

c. Economics as a Science
    i. Science is the study of those things having, or appearing to have, an exact, objective, factual, systematic, or methodological basis. – American Heritage Dictionary
        1. World calls it spontaneous order – order emerged out of the universe
        2. Christianity calls it natural order – God brought order to the world
    ii. "The existence of a distinct science of economics can be traced back to the discovery that there is a predictable regularity to the interaction of people in society." – Callahan
d. Economics as an Art
    i. "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. - Henry Hazlitt, Economics in One Lesson
e. Discussion questions.
    i. How does Laffer define economics?

ii. Discuss Laffer's definition in light of the above definitions. What do they have in common? What are the differences?
iii. What do you think economics is?
iv. What is the relationship between economics and praxeology?
v. Does economics judge whether actions are good or bad? Does it tell a man how he should act, or show a man how he must act to attain definite ends?
vi. What does it mean to call economics a science? An art?
vii. Is economics a science, an art, or both? Explain.
viii. How does your answer to the previous question help you understand how economics plays a role in public policy?
ix. Can anyone understand the worth—good or bad—of public policies unless one understands economics?
x. Laffer talks about the immutability of economic laws. What does he mean by this?
xi. What are some economic laws you can think of?
xii. What is the Law of Unintended Consequences Laffer refers too? What does it have to do with economics?
xiii. How do we know that economic laws are true?
xiv. Can people prove or disprove economic laws with an analysis of data?
xv. Does an economist care whether a person is being selfish or selfless? In other words, does an economist care why a person acts? Explain.
xvi. Why is it important to understand human action when it comes to understanding economics?
xvii. Explain the role that human action plays in the development of economic laws, so that we can call economics a science.

IV. Life, Liberty, and Property

a. "Adam Smith began with scarcity as the heart of his economic analysis: the famous third chapter in The Wealth of Nations (1776). This was on the division of labor/specialization. He set the pattern for subsequent economic theorists. Smith should have started with ownership. He should have made private ownership the bedrock foundation of his analysis. By beginning with the division of labor, he committed a strategic error. Critics from the Left immediately challenged him. They were also able to invoke the division of labor. They invoked state planning as a way to deal with the problems of coordinating the division of labor. The fundamental economic issue, ownership, did not become a major focus of economic theory until the 1950's. So, for almost two centuries, the crucial economic issue had not been central in free market economic analysis." – Gary North
b. In a world of ***scarcity***, how do we live "without our starving to death or killing one another in a barbaric struggle for survival?"
c. Two ways: Production and Exchange or Charity; both presuppose private property
d. The Third Way: Theft; it also presupposes private property
e. One can't be a steward of someone else's property: Efforts to do so, i.e., taxation, regulation, and condemnation, reduce prosperity and corrupt morality

    i. "He will take the best of your fields and vineyards and olive orchards and give them to his servants. He will take the tenth of your grain and of your vineyards and give it to his officers and to his servants." – 1 Samuel 8:14-15

f. Questions of public policy are not ultimately questions of utility, they are questions of morality and ethics
    i. Does a policy promote liberty or theft?
    ii. Why is a government solution to the problem of scarcity proposed by a few bureaucrats and special interests better than one determined by millions of people in the marketplace?

g. "Property owners do not acquire a constitutionally protected vested right in property uses." – Texas Supreme Court; City of University Park v. Benners, 485 SW 2d 773 (1972). Such is the law of the land when it comes to property rights in Texas. Texans have title to the dirt or water or other minerals that make up the land they own, but do not have the right to use them without permission from the state. As a result, Texas courts grant municipalities wide latitude in placing regulatory restrictions on land. A common practice that takes advantage of this is cities restricting development on lands because of aesthetic, economic, or environmental concerns. Local zoning ordinances are often the way these restrictions get put into place—except in Houston, which is the only major city in Texas and the U.S. that doesn't have zoning. In other cities, zoning and rezoning of property can be done with little concern for the impact on property owners. Rezoning and other city ordinances that restrict use and diminish the value of a property are generally considered a legitimate "exercise of police power" as long as they "accomplish a legitimate goal" and are "reasonable." In other words, cities can prohibit an activity or even force a business to close through zoning without it being considered a taking, in most cases. Because property owners have no right to use their property without permission, the courts reason that if a government wants to prohibit "nonconforming uses," i.e., uses that no longer comply with a new city ordinance, a property owner simply needs to have a little time to recoup their investment, through amortization. There is no consideration of the income, jobs, and property value that vanishes when the nonconforming use is finally terminated. As the Houston Court of Appeals explains, "Amortization is a valid technique to allow owners of property to recoup their investment in property that becomes nonconforming as a result of the regulations. … In the Benners case, the owner had 25 years notice that the nonconforming use would have to terminate. The court determined that this was sufficient time to recoup any loss in property value caused by the zoning ordinance." (Eller Media Co. v. City of Houston, 101 SW 3d 668, Houston 2003) – Bill Peacock, in Eminent Domain: Balancing the Scales of Justice.

Session Two

Capital

and Production

Thinking Economically

Thinking Economically

Turning the World Upside Down
Entrepreneurship, Production, & Innovation

- The Myth of Market Failure
- Entrepreneurship: Putting Capital to Work
- Production: The Answer to Scarcity
- Innovation: Lengthening the Production Process

Thinking Economically

The Myth of Market Failure

- Good business v. bad business: how can we tell the difference?
  - Profits driven by consumers rather than government
  - Yet government regulation does exactly that—drive profits (and losses)
- Do markets fail?
  - No. Markets don't fail, people fail. Uncertain world because people change.
  - Myth of market failure, monopolies, and externalities
- How do we deal with our imperfections?
  - Give power to people to take our property/wealth from us and tell us what to do based on what they think is best for us?
  - Turn to people who are willing to risk their own money and time and reputation to benefit us?
- Markets reflect people at their best; government at their worst

Thinking Economically

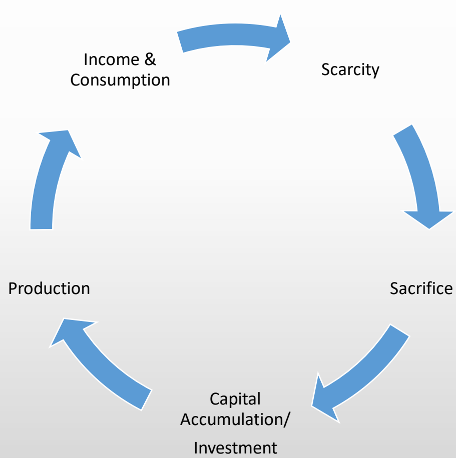
Entrepreneurship

- Why do we need entrepreneurs?
- Four areas of uncertainty
  - Quantity demanded
  - Price
  - Technological longevity
  - Competition
- The capitalist entrepreneur: one who invests, i.e., risks, capital used in the production process in the face of uncertainty
- Entrepreneurial profit and loss
  - The result of the how well one correctly judges future prices
  - Calculation

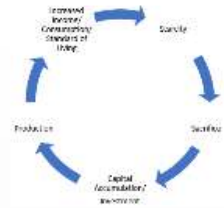
Entrepreneurship

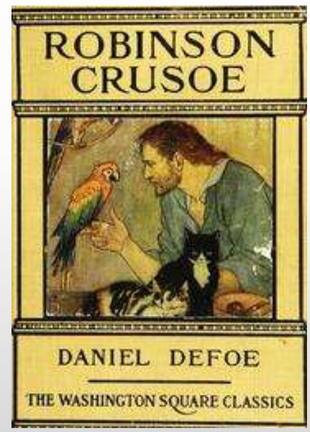
- Entrepreneurs as intermediaries
  - Between producers and consumers
- Where do consumers get their income?
  - By being producers
- Key characteristics of entrepreneurs
  - servanthood, perseverance
- Entrepreneurs determining the course of production v. consumer sovereignty

Production Basics
The Production/Consumption Cycle



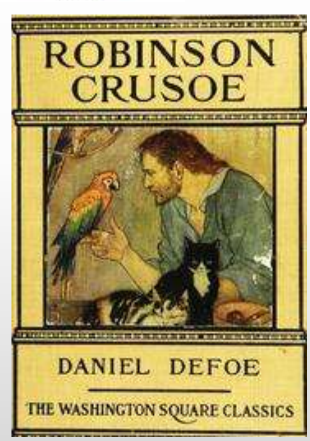
Scarcity & Sacrifice





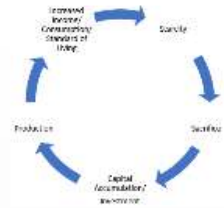
- What is scarcity?
  - "While on the one hand man is prone to 'unlimited' wants, he is also confounded by the fact that the resources or means required to satisfy his wants are relatively limited.'"
- What is the relationship between scarcity and human action? Between scarcity and production?
- What does one sacrifice in order to produce?
  - Present consumption (including leisure)
- What is the motivation for sacrifice?
  - Greater future consumption (including leisure)
- How do the concepts of scarcity & sacrifice fit into today's differing worldviews regarding economic & political policy?

Capital Accumulation, Investment, & Production

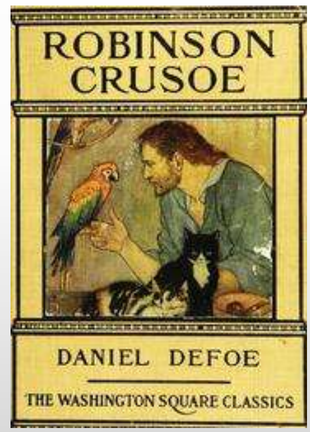


- Capital Accumulation
  - Work overtime on new project
  - Work less time on existing project
  - Store goods to work on new project
- Investment
  - Crusoe's investment is simple
  - We withhold from income to invest in financial assets; firms can withhold from distributing profits to acquire new means of production
- Purpose of production
- Factors of production
  - Land, labor, and capital goods

Production & Economic Growth



- Production as utility creation
  - Form utility
  - Place utility (goods or people)
  - Time utility (loans & storage)
- Production v. Consumption and the Standard of Living
  - crux of capital accumulation and economic growth: higher consumption levels in the future rest essentially upon the sacrifice of some consumption in the present.



Innovation & Growth Lengthening the Production Process

- Examining Production: The Evenly Rotating Economy
  - Not perfect competition
    - Homogeneous product, multiple small firms,
    - Price takers, perfect knowledge
  - Things just stay the same
    - No changes in consumer demand
    - No changes in producer supply
    - No changes in interest rates
    - No changes in prices

Thinking Economically

Income to Land and Labor

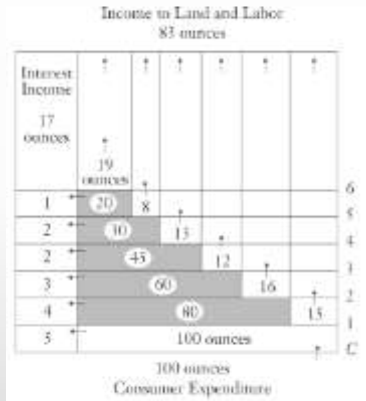
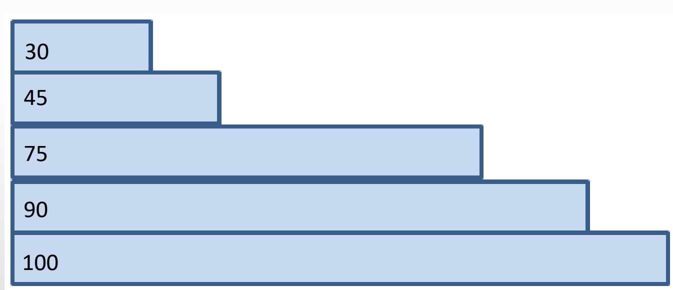


FIGURE 41. INCOME ACCRUING TO FACTORS AT VARIOUS STAGES OF PRODUCTION

Thinking Economically

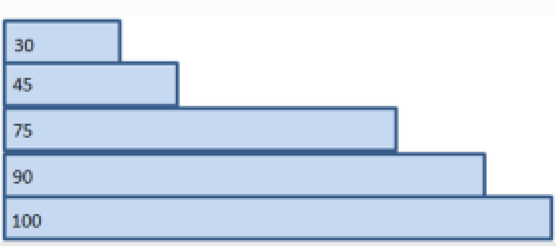
Basics

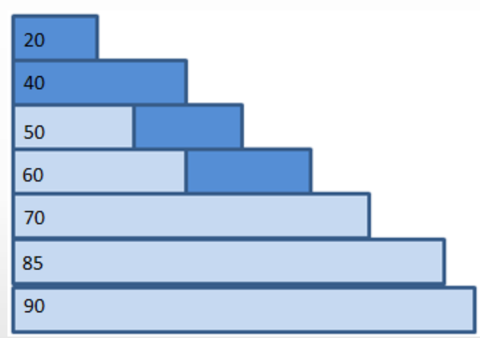


Introduction of Change

- A shift in consumer time preference
- What is time preference?
  - the assumption that, all else being equal, people prefer a given end to be achieved sooner rather than later
- Derived from our understanding of human action
  - If people did not prefer to attain their ends sooner rather than later they would never act
- What happens to consumption, savings, and interest rates when consumer time preference shifts? Toward the present? Toward the future?

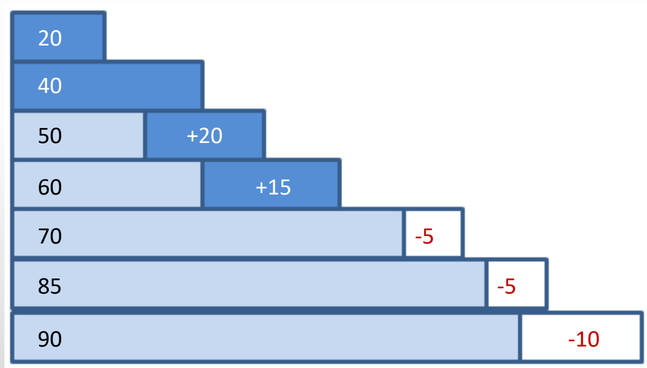
What Happened?





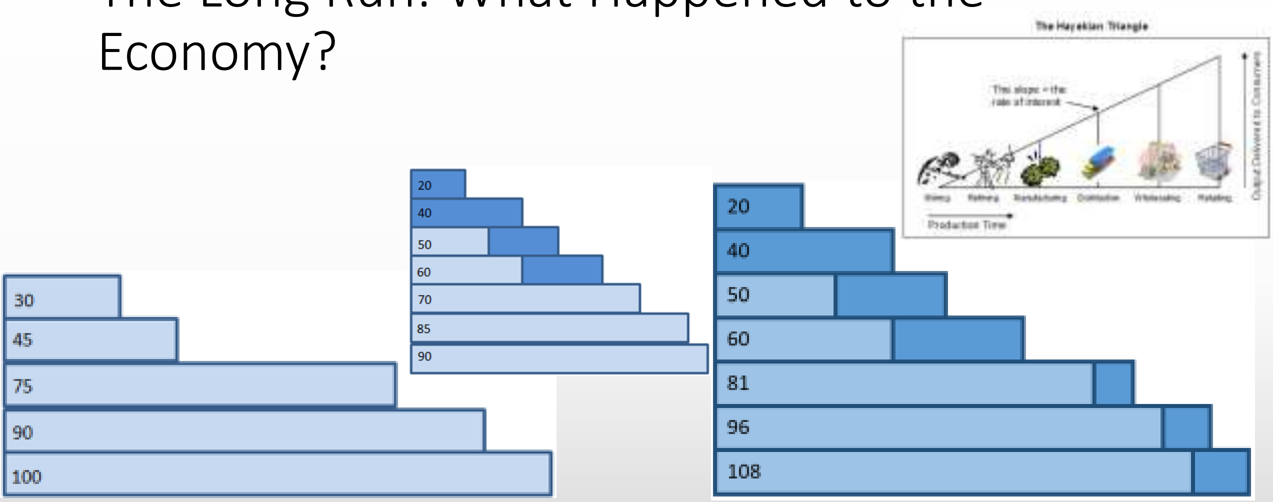
Thinking Economically

The Short Run: Where did the Money Go?



Thinking Economically

The Long Run: What Happened to the Economy?



Increased Wealth thru Economic Growth

Innovation: Lengthening the Production Process

Eugen von Bohm-Bawerk

- Current production is the most direct production: the most valuable and the shortest. Why?
  - Human action and time preference
- Any increase in capital goods can only serve to lengthen production
  - the shortest process has already been chosen; more capital is required because the most valuable one, given existing capital, has already been chosen
  - Capital is ALWAYS looking for more value, i.e., innovation, because of time preference
- Capital accumulation, a product of lower time preference, allows a longer, more valuable production process to become the most direct production
- Longer process more productive in two ways: 1) producing more of the same good or 2) producing a new good impossible in the shorter process
- Entrepreneurship: is the longer, innovative process always more valuable?

Innovation and Growth Lengthening the Production Process

- Innovation: investment in a new production process because the entrepreneur believes that resources are misallocated based on future prices
- Why? 1) change in consumer preferences, 2) change in supply, 3) new technology (knowledge), etc.
- What stands in the way of innovation, i.e., investment in a new, longer, more valuable process?
- What is the cost of innovation?
  - Effort, time, and capital
- What is the driver of innovation?
  - Saved capital, not technology
- Example: Powered flight—small airplane engines, lightweight airframes
- Example: Self-driving cars—avoid other cars, pedestrians, and other hazards (start, stop, and maintain speed; stay in or change lanes) and navigate to destination
  - Cars – 1900; Airplane autopilot – 1912; Radar – 1930s; Motion sensors – 1940s; Navigation (GPS) – 1960s; Computers – 1990s;
- Abundance: successful investment in longer processes results in economic growth and greater wealth

Production

Turning the World Upside Down: Entrepreneurship and the Production Process Thinking Economically Session 2 Study Guide

Required Reading:
Chapter 4, "Production, Income, and Economic Growth," in *Foundations of the Market-Price System* by Milton M. Shapiro
The Entrepreneur as Servant by Robert A. Sirico
Are Successful Entrepreneurs Born or Made? by Jeff Sandefer

These excerpts, which are included below the discussion questions:
Man, Economy, and State by Murray Rothbard, Chap. 8, "Production: Entrepreneurship and Change" – See below.
Profit and Loss by Ludwig von Mises, Section A 1. The Emergence of Profit and Loss

Supplemental Reading (optional):
I, Pencil, by Leonard Read
So You Want to be an Entrepreneur? by Jeff Sandefer

I. Entrepreneurship
  a. Read:
    i. The four sections on pp. 72-74 in *Foundations of the Market-Price System* by Milton M. Shapiro, Chap. 4, beginning with the section, "Innovation Is No Guarantor of Profits;"
    ii. *The Entrepreneur as Servant* by Robert A. Sirico;
    iii. *Are Successful Entrepreneurs Born or Made*? by Jeff Sandefer;
    iv. *So You Want to be an Entrepreneur?* by Jeff Sandefer (supplemental); and
    v. "Section A 1. The Emergence of Profit and Loss" in *Profit and Loss* by Ludwig von Mises. (see below)
  b. Discussion Questions
    i. Describe the process of entrepreneurship.
    ii. What distinguishes an entrepreneur from the rest of society? What is an entrepreneur's primary role? Are entrepreneurs more technological innovators or movers of capital?
    iii. The entrepreneur is an intermediary between what two parties? How is entrepreneurship manifested in the intermediary role of the firm? Why do the tasks of the firm involve entrepreneurship?
    iv. What role do prices play in entrepreneurship? Shapiro says that firms "have to work back from price." What does he mean by this?
    v. Why do firms have to discount future prices?
    vi. Is it possible for entrepreneurs—or anyone else—to calculate profit and efficiently allocate resources without prices? Why or why not? What

actions take place as the result of the calculations made by an entrepreneur?

vii. Is skill, character or luck more important for a successful entrepreneur?
viii. What are some of the key characteristics and skills of entrepreneurs?
ix. What are the factors involved in entrepreneurial profit and entrepreneurial loss, according to Mises? How do they both emerge?
x. How do entrepreneurs determine the course of production, according to Mises?
xi. If entrepreneurs determine the course of production, how are consumers sovereign?

II. Production I: The Basics
  a. Read Chap. 4, "Production, Income, and Economic Growth, in *Foundations of the Market-Price System* by Milton M. Shapiro.
  b. Discussion Questions
    i. What is scarcity? How does the reality of scarcity lead inevitably to production? Why have we shifted over time from direct use production to exchange-based production?
    ii. What are the two basic types of production, according to Shapiro? Which one is more prevalent today?
    iii. Why does man want to engage in production; in other words, what is the ultimate purpose of production? What does this have to do with human action?
    iv. The three factors of production are ______________, ________________, and __________________.
    v. What else is needed to engage in production in addition to the three factors?
    vi. What does Shapiro say are the two types of capital goods?
    vii. People are both producers and consumers. Thinking about this, how is the relationship between producers and consumers different in the modern market economy when compared to a primitive economy? What does this difference introduce into the production process?
    viii. According to Shapiro, what four things does a producer have uncertainty about?
    ix. What are the three types of utility added through production?
    x. The utility aspect of production enables increased ________________ by people.
    xi. Which comes first, production or consumption? Explain.
    xii. Where do consumers get their money?
    xiii. What does Shapiro say about the relationship of production to consumer spending? Explain.
    xiv. Is the demand for the factors of production inherent in the factors or derived from something else? Explain.
    xv. Production requires investment. Where do the funds, i.e., capital, for investing first come from? Think about this in light of Robinson Crusoe.

III. Production II: The Production Process

a. Read
    i. The edited version below of Chap. 8, "Production: Entrepreneurship and Change," in *Man, Economy, and State* by Murray Rothbard.
    ii. The excerpt below from *I, Pencil* by Leonard Read.
b. Discussion Questions
    i. What change in consumers' preferences leads to a net increase in savings?
    ii. According to Rothbard, what happens to consumer spending when there is an increase in net savings? Where does the money go?
    iii. Define time preference.
    iv. What happens to consumption, prices, and interest rates when consumers' time preference shifts toward future consumption?
    v. What happens to consumption, prices, and interest rates when consumers' time preference shifts toward current consumption?
    vi. What happens to production and sales when consumers' time preference shifts toward future consumption?
    vii. What happens to production and sales when consumers' time preference shifts toward current consumption?
    viii. How do you think a decrease in consumer preference for immediate consumption (and thus an increase in consumer preference for future consumption) might be signaled to producers?
    ix. Explain what Rothbard means when he says that the production process lengthens. When the production process narrows. These concepts are shown graphically in Figures 41 & 60 below.
    x. Why does the production process narrow and lengthen when there is an increase in net savings?
    xi. What are the benefits from a lengthened production process?
    xii. What do you learn about this in I, Pencil?
    xiii. Does the production process always lengthen when investment increases?
    xiv. What is the ultimate impact on the economy from this shift to net savings?
    xv. What is the relationship between capital accumulation and economic growth and our standard of living?
    xvi. Why would consumers be motivated to reduce consumption today?
    xvii. What do consumers have to do today in order to accumulate capital?

IV. Production III: Technology and Capital
a. Read
    i. Chap. 4, "Production, Income, and Economic Growth, p. 63 ff, in *Foundations of the Market-Price System* by Milton M. Shapiro; and
    ii. "5. The Adoption of a New Technique," in Chap. 8, "Production: Entrepreneurship and Change," of *Man, Economy, and State* by Murray Rothbard (see excerpt below).
b. Discussion Questions

i. Is technology something physical? What is Shapiro's definition of technology? Explain.
ii. Which do you think has been scarcer throughout history, technology or capital? Why?
iii. Which is more important, technology or capital, at any point in time when it comes to economic growth/increasing the standard of living, technology or capital? Explain.
iv. According to Shapiro, why would producers invest in new goods improved by technology?
v. Explain Schumpeter's view of the difference between innovation, technology, and invention.
vi. Other than a scarcity of capital, why else does Rothbard say that new technology is not immediately adopted?
vii. What is the importance of consumer spending in an economy? How is this captured in the term consumer sovereignty?
viii. Does innovation guarantee profits? Why or why not?
ix. Identify some situations in the world today where the lack of capital, rather than technology, is having a detrimental impact on people.

Additional Readings

***Profit and Loss,* Ludwig von Mises, from Section A 1. The Emergence of Profit and Loss**:
In the capitalist system of society's economic organization the entrepreneurs determine the course of production. In the performance of this function they are unconditionally and totally subject to the sovereignty of the buying public, the consumers. If they fail to produce in the cheapest and best possible way those commodities which the consumers are asking for most urgently, they suffer losses and are finally eliminated from their entrepreneurial position. Other men who know better how to serve the consumers replace them. If all people were to anticipate correctly the future state of the market, the entrepreneurs would neither earn any profits nor suffer any losses. They would have to buy the complementary factors of production at prices which would, already at the instant of the purchase, fully reflect the future prices of the products. No room would be left either for profit or for loss. What makes profit emerge is the fact that the entrepreneur who judges the future prices of the products more correctly than other people do buys some or all of the factors of production at prices which, seen from the point of view of the future state of the market, are too low. Thus the total costs of production — including interest on the capital invested — lag behind the prices which the entrepreneur receives for the product. This difference is entrepreneurial profit. On the other hand, the entrepreneur who misjudges the future prices of the products allows for the factors of production prices which, seen from the point of view of the future state of the market, are too high. His total costs of production exceed the prices at which he can sell the product. This difference is entrepreneurial loss. Thus profit and loss are generated by success or failure in adjusting the course of production activities to the most urgent demand of the consumers.

Once this adjustment is achieved, they disappear. The prices of the complementary factors of production reach a height at which total costs of production coincide with the price of the product. Profit and loss are ever-present features only on account of the fact that ceaseless change in the economic data makes again and again new discrepancies, and consequently the need for new adjustments originate.

Man, Economy, and State by Murray Rothbard

Explanation of Graph

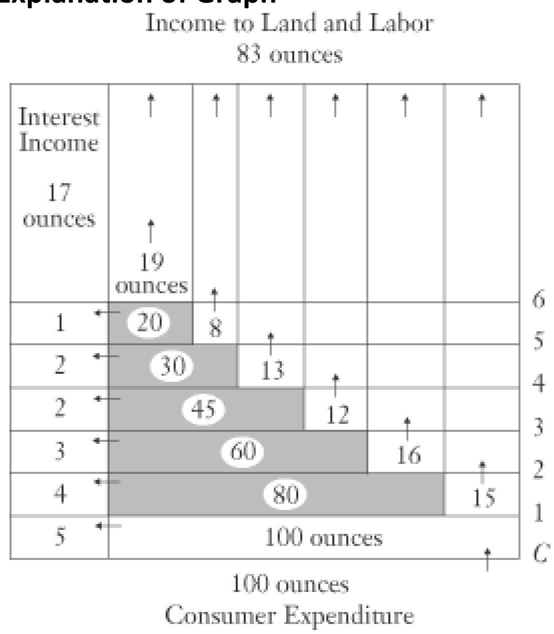


FIGURE 41. INCOME ACCRUING TO FACTORS AT VARIOUS STAGES OF PRODUCTION

The structure of production and payment depicted in this basic diagram is as follows: Consumers spend 100 ounces of gold on the good in question. Of the 100 ounces, five ounces go as profit to the sellers of the consumers' good, and 95 are paid out to the owners of factors. In our example, 15 ounces go for the use of land and labor (original) factors, and 80 go into the purchase of factor services of capital goods of a higher order. At the second stage, capitalists receive 80 ounces in revenue from the sale of their product.

Of the 80 ounces, 16 go into the purchase of land and labor factors, and four accrue as profit to the second-level capitalists. The remaining 60 are used for the purchase of higher-order capital goods. The same process is repeated until, on the highest stage, the highest-order capitalists receive 20 ounces of revenue, retain one for themselves, and pay out 19 to land and labor factors. The sum total of income to land and labor factors is 83 ounces; total profit to capitalists is 17 ounces.

The graph below is basically the same one as the one above; however, rather than showing the distribution of revenue in an unchanging economy as above, it is being used to show how the distribution of income changes among capitalists and owners of the factors of production when consumers spend less and save more.

Excerpts from Rothbard, Chap. 8

2. The Effect of Net Investment

[When consumers time preferences shift in such a way to prefer future over present consumption, they will start spending less and saving more. In this case], it is clear that the volume of money incomes to Capitalists [will be reduced]. The amount that they have to apportion to original factors and to Capitalists$_2$ is therefore also considerably decreased. Thus, from the side of final consumers' spending, an impetus toward declining money incomes and prices is sent along the production structure. In the meanwhile, however, *another force* has concurrently come into play. The [funds previously spent by consumers has] not been lost to the system. They are in the process of being invested in the economy, their owners ranging throughout the economy looking for maximum interest returns on their investment. The new savings have [in fact increased] the ratio of gross investment to consumption. A "narrower" consumption base must support a larger amount of producers' spending. How can this happen, especially since the lower-rank capitalists must also receive a lower aggregate income? The answer is: in only one way—by shifting investment further up the ladder to the higher-order production stages. Simple investigation will reveal that the only way that so much investment can be shifted from the lower to the higher stages, while preserving uniform (lowered) interest differentials (cumulative price spreads) at each stage, is *to increase the number of productive stages in the economy*, i.e., to lengthen the structure of production. The impact of net saving on the economy, i.e., of increased total savings, is to lengthen and narrow the structure of production, and this procedure is viable and self-supporting, since it preserves essential price spreads from stage to stage. The diagram in Figure 60 illustrates the impact of net saving.

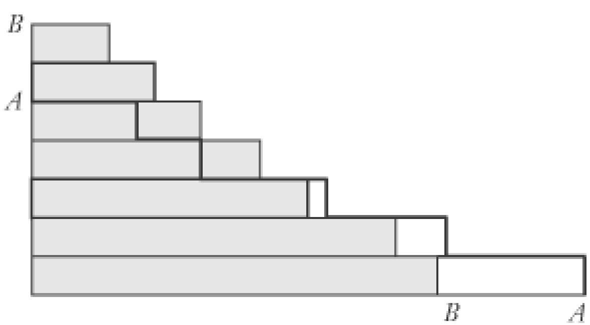


FIGURE 60. THE IMPACT OF NET SAVING

In this diagram we see the narrowing and the lengthening of the structure of production. The heavy line *AA* outlines the original structure. The bottom rectangle—consumption—is narrowed with the addition of new savings. As we go up in stepwise fashion—the steps in these diagrams accounting for the interest spreads[7]—the new production structure *BB* (the shaded area) becomes relatively less and less narrow compared to the original structure, until it becomes wider in the upper registers, and finally adds new and higher stages.

4. Capital Accumulation and the Length of the Structure of Production

We have been demonstrating that investment lengthens the structure of production.

Böhm-Bawerk is the great founder of production-structure analysis, but unfortunately he left room for misinterpretation by identifying capital accumulation with adopting "more round-about" methods of production. Thus, consider his famous example of the Crusoe who must first construct (and then maintain) a net if he wishes to catch more than the number of fish he can catch without any capital. Böhm-Bawerk stated: “The roundabout ways of capital are fruitful but long; they procure us more or better consumption goods, but only at a later period of time.”[24] Calling these methods “roundabout” is definitely paradoxical; for do we not know that men strive always to achieve their ends in the most direct and shortest manner possible? As Mises demonstrates, rather than speak of the higher productivity of roundabout methods of production, “it is more appropriate to speak of the higher physical productivity of production processes requiring more time” (longer processes).

Now let us suppose that we are confronted with an array of possible production processes, based on their physical productivities. We may also rank the processes in accordance with their *length*, i.e., in terms of the waiting time between the input of the resources and the yielding of the final product. The longer the waiting period between first input and final output, the greater the disutility, *ceteris paribus,* since more time must elapse before the satisfaction is attained.

The first processes to be used will be those most productive (in value and physically) *and* the shortest. No one has maintained that *all* long processes are more productive than *all* short processes. The point is, however, that all short *and* ultra-productive processes will be the first ones to be invested in and established. Given any present structure of production, a new investment will not be in a *shorter* process because the shorter, more productive process would have been chosen first.

As we have seen, there is only one way by which man can rise from the ultra-primitive level: through investment in capital. But this cannot be accomplished through short processes, since the short processes for producing the most valuable goods will be the ones first adopted. Any increase in capital goods can serve only to lengthen the structure, i.e., to enable the adoption of longer and longer productive processes. Men will invest in longer processes more productive than the ones previously adopted. They will be more productive in two ways: (1) by producing *more* of a previously produced good, and/or (2) by producing a new good that could not have been produced at all by the shorter processes. Within this framework these longer processes *are the most direct* that must be used to attain the goal—not more roundabout. Thus, if Crusoe can catch 10 fish per day directly without capital and can catch 100 fish per day with a net, building a net should not be considered as a “more roundabout method of catching fish,” but as the “most direct method for catching 100 fish a day.” Furthermore, no amount of labor and land without capital could enable a man to produce an automobile; for this a certain amount of capital is required. The production of the requisite amount of capital is the shortest and most direct method of obtaining an automobile.

Any new investment will therefore be in a longer and more productive method of production. Yet, if there were no time preference, the most productive methods would be invested in *first*, regardless of time, and an increase in capital would not cause more productive methods to be used. The existence of time preference acts as a brake on the use of the more productive but longer processes. Any state of equilibrium will be based on the time-preference, or pure interest, rate, and this rate will determine the amount of savings and capital invested. It determines capital by imposing a limit on the length of the production processes and therefore on the maximum amount produced. A lowering of time preference, therefore, and a consequent lowering of the pure rate of interest signify that people are now more willing to wait for any given amount of future output, i.e., to invest more proportionately and in longer processes than heretofore. A rise in time preference and in the pure interest rate means that people are less willing to wait and will spend proportionately more on consumers' goods and less on the longer production processes, so that investments in the longest processes will have to be abandoned.

One qualification to the law that increased investment lengthens production processes appears when investment turns to a type of good which is less useful than the goods previously acquired, yet which has a shorter process of production than some of the others. Here the investment in this process was checked, not by the length of the process, but by its inferior (value) productivity. Yet even here the structure of production was lengthened, since people have to wait longer for the new *and* the old goods than they previously did for the old good. New capital investment always lengthens the overall structure of production.

What of the case where a technological invention permits a more productive process with a lesser amount of capital investment? Is this not a case in which increased investment *shortens* the production structure? Up to this point we have been assuming technological knowledge as given. Yet it is not given in the dynamic world. Technological advance is one of the most dramatic features of the world of change. What then of these "capital-saving" inventions? One interesting example was cited by Horace White in a criticism of Böhm-Bawerk. Oil was produced first by ships hunting in the Arctic for whales, the whale oil being processed from the whales, etc., an obviously lengthy production process. Later an invention permitted people to bore for oil in the ground, thereby immeasurably shortening the production period.

Aside from the fact that, empirically, most inventions do not shorten physical production processes, we must reply that the limits at any time on investment and productivity are a *scarcity of saved capital, not* the state of technological knowledge. In other words, there is always an unused shelf of technological projects available and idle. This is demonstrable by the fact that a new invention is not immediately and instantaneously adopted by all firms in the society. Therefore, any further investment will lengthen production processes, many of them more productive because of superior technique. A new invention does not automatically impel itself into production, but first joins the unused array. Further, in order for the new invention to be used, *more capital must be invested. The ships for whaling have already been built; the oil wells and machinery, etc., must be created anew.* Even the newly invented method will yield a greater product only through further investment in longer processes. In other words, the only way to obtain more oil now is to invest more capital in more machinery and lengthier production periods in the oil-drilling business. As Böhm-Bawerk pointed out, White's criticism would apply only if the invention were *progressively* capital-saving, so that the product would always increase with the shortening of the process. But in that case, boring for oil with one's bare hands, unaided by capital, would have to be more productive than drilling for oil with machinery.

Böhm-Bawerk drew the analogy of an agricultural invention applied to two grades of land, one grade previously yielding a marginal product of 100 bushels of wheat, the lower grade yielding 80 bushels. Now suppose use of the invention raises the marginal product of the lower-grade land to 110 bushels. Does this mean that the poorer land *now* yields more than the fertile land and that the effect of agricultural inventions is to make poorer lands more productive than fertile ones? Yet this is precisely analogous to White's position, which maintains that inventions may cause shorter production processes to be more productive! As Böhm-Bawerk pointed out, it is obvious that the source of the error is this: inventions increase the physical productivity of *both* grades of land. The better land becomes *still* better. Similarly, perhaps it is true that an invention will cause a shorter process to be more productive now than a longer process was previously. But this does not mean that it is superior to *all* longer processes; longer processes using the invention will still be more productive than the shorter ones. (Boring for oil *with* machinery is more productive than boring for oil without machinery.)

Technological inventions have received a far more important place than they deserve in economic theory. It has often been assumed that production is limited by the "state of the arts"—by technological knowledge—and therefore that any improvement in technology will immediately show itself in production. Technology does, of course, set a limit on production; no production process could be used at all without the technological knowledge of how to put it into operation. But while knowledge is a limit, *capital* is a narrower limit. It is logically obvious that while capital cannot engage in production beyond the limits of existing available knowledge, knowledge can and does exist without the capital necessary to put it to use. Technology and its improvement, therefore, play no *direct* role in the investment and production process; technology, while important, must always *work through* an investment of capital. As was stated above, even the most dramatic capital-saving invention, such as oil-drilling, can be put to use only by saving and investing capital.

The relative unimportance of technology in production as compared to the supply of saved capital becomes evident, as Mises points out, simply by looking at the "backward" or "underdeveloped" countries. What is lacking in these countries is not knowledge of Western technological methods ("know-how"); that is learned easily enough. The service of imparting knowledge, in person or in book form, can be paid for readily. What is lacking is the supply of saved capital needed to put the advanced methods into effect. The African peasant will gain little from looking at pictures of American tractors; what he lacks is the saved capital needed to purchase them. That is the important limit on his investment and on his production.

A businessman's new investment in a longer and more physically productive process will therefore be made from a sheaf of processes previously known but unusable because of the time-preference limitation. A lowering of time preferences and of the pure interest rate will signify an expansion of saved capital at the disposal of investors and therefore an expansion of the longer processes, the time limitation on investment having been weakened.

Some critics charge that not all net investment goes to lengthening the structure—that new investments might duplicate pre-existing processes. This criticism misfires, however, because our theory does not assume that net saving must be invested in an actually longer process in some specific line of production. A longer production structure can just as well be achieved by a shift from consumption to investment that will lengthen the *aggregate* production structure by greater investment in already existing longer processes, accompanied by less investment in existing shorter processes. Thus, in the case of Crusoe mentioned above, suppose that Crusoe now invests in a *second* net, which will permit him to catch a total of 150 fish a day. The structure of production is now lengthened even though the second net may be no more productive than the first. For the total period of production, from the time he must build and rebuild his total capital until his product arrives, is now considerably longer. He must now cut down again on present consumption (including leisure) and work on his second net.

5. The Adoption of a New Technique

At any given time, then, there will be a shelf of available and more productive techniques that remain unused by many firms continuing with older methods. What determines the extent to which these firms adopt new and more productive techniques?

The reason that firms do not scrap their old methods immediately and begin afresh is that they and their ancestors have invested in a certain structure of capital goods. As times and tastes, resources, and techniques change, much of this capital investment becomes an *ex post* entrepreneurial error. If, in other words, investors had been able to foresee the changed pattern of values and methods, they would have invested in a far different manner. Now, however, the investment has been made, and the resulting capital structure is a given residue from the past that supplies the resources they have to work with. Since costs in the *present* are only present and future opportunities forgone, and bygones are bygones, existing equipment must be used in the most profitable way. Thus, there undoubtedly would have been far less investment in railroads in late nineteenth-century America if investors had foreseen the rise of truck and plane competition. Now that the existing railroad equipment remains, however, decisions concerning how much of it is to be used must be based on current and expected future costs, not on past expenses or losses.

An old machine will be scrapped for a new and better substitute if the superiority of the new machine or method is great enough to compensate for the additional expenditure necessary to purchase the machine. The same applies to the shifting of a plant from an old location to a superior new location (superior because of greater access to factors or consumers). At any rate, the adoption of new techniques or locations is limited by the usefulness of the already given (and specific) capital-goods structure. This means that those processes and methods will be adopted at any time which will best satisfy the desires of the consumers. The fact that investment in a new technique or location is unprofitable means that the use of capital in the new process at the cost of scrapping the old equipment is a waste from the point of view of satisfying consumer wants. How fast equipment or location is scrapped as obsolescent, then, is not decided arbitrarily by businessmen; it is determined by the values and desires of consumers, who decide on the price and profitability of the various goods and on the values of the necessary nonspecific factors used to produce these goods.

As is often true, critics of the free market have attacked it from two contradictory points of view: one, that it unduly slows down the rate of technological improvement from what it could and should be; and, two, that it unduly accelerates the rate of technological improvement, thereby unsettling the peaceful course of society. We have seen that a free market will, as far as the knowledge and foresight of entrepreneurs permit, produce so that factors are best allocated to satisfy the wishes of consumers. Improvement in productivity through new techniques and locations will be balanced against the opportunity costs forgone in value product from using the existing old plant. And ability in entrepreneurial foresight will be assured as much as possible by the market's process of "selection" in "rewarding" good forecasters and "penalizing" poor ones proportionately.

***I, Pencil* by Leonard Read**

My family tree begins with what in fact is a tree, a cedar of straight grain that grows in Northern California and Oregon. Now contemplate all the saws and trucks and rope and the countless other gear used in harvesting and carting the cedar logs to the railroad siding. Think of all the persons and the numberless skills that went into their fabrication: the mining of ore, the making of steel and its refinement into saws, axes, motors; the growing of hemp and bringing it through all the stages to heavy and strong rope; the logging camps with their beds and mess halls, the cookery and the raising of all the foods. Why, untold thousands of persons had a hand in every cup of coffee the loggers drink! The logs are shipped to a mill in San Leandro, California. … Here is an astounding fact: Neither the worker in the oil field nor the chemist nor the digger of graphite or clay nor any who mans or makes the ships or trains or trucks nor the one who runs the machine that does the knurling on my bit of metal nor the president of the company performs his singular task because he wants me. Each one wants me less, perhaps, than does a child in the first grade. Indeed, there are some among this vast multitude who never saw a pencil nor would they know how to use one. Their motivation is other than me. Perhaps it is something like this: Each of these millions sees that he can thus exchange his tiny know-how for the goods and services he needs or wants. I may or may not be among these items.

Session Three

Value, Exchange & Governance

Thinking Economically

Thinking Economically

What We've Discussed so Far

- Praxeology and Human Action
- The Purpose of Government
- Private Property
- Entrepreneurship
- The Production/Consumption Cycle
- The Myth of Market Failure

Session 3 Overview

- Value
- Voluntary Exchange
- Unfair Prices
- Externalities
- Monopolies
- Design of Government

Value

- Functions of Determining Value Implied by Human Action
  - Only individuals act
  - Individuals have preferences
  - Preferences are subjective
  - Preferences are ordinal, not cardinal
  - Individual's preferences cannot be combined
  - Preferences are expressed marginally, i.e., unit by unit
- Value is Subjective, not Objective
  - The paradox of value
  - Objective or Intrinsic (labor) theory of value v. subjective theory of value
  - Laws of diminishing marginal utility and of increasingly marginal costs
- The Value → Liberty Connection

Thinking Economically

Voluntary Exchange

- Mutual benefit of exchange of goods and services: “To understand the market economy, we must remind ourselves that every activity is simply a voluntary exchange between two or more consenting parties. That’s why both parties to an exchange benefit—they wouldn’t have agreed to it otherwise!” – Art Laffer
- The connection of value and exchange: “It can be seen that in the market economy, characterized by the production of goods and services for subsequent exchange by a common medium of exchange, both ***use and exchange values*** are a vital part of the economic process.” – Thomas Taylor
- Consumer Sovereignty: “The capitalists, the enterprisers, and the farmers are instrumental in the conduct of economic affairs. They are at the helm and steer the ship. But they are not free to shape its course. They are not supreme, they are steersmen only, bound to obey unconditionally the captain's orders. The captain is the consumer.” – Ludwig von Mises
- The Voluntary Exchange → Liberty Connection

Thinking Economically

Unfair Prices

- Before we talk unfair prices, let start with just prices: what are they?
  - the ratios at which goods and services trade against each other
- What important and necessary roles do prices play in the market?
  - Information (scarcity), calculation (of profits), stability (planning)
- Do prices measure value? Who sets prices?
- Aristotle: the only fair exchange is an equal exchange
- What are implications of the theories of value regarding “fair prices”?
- How does voluntary exchange undercut the concept of fair prices?
- The Market Price → Liberty Connection

Thinking Economically

Externalities

- What is an “externality”? What are some common examples?
- What two main ways does government deal with externalities?
- Critique the understanding of externalities as market failure from the perspective of: property rights; prices; value; and liberty
- According to Coase, what are the two main foundations needed for markets to deal with externalities?
  - Well-defined property rights
  - Low transaction costs
- What are the benefits of the market-approach to externalities?
  - Voluntary, more efficient/effective, and costs less
  - Externalities resolved voluntarily when benefits outweigh costs
- The Property Rights Approach → Liberty Connection

Thinking Economically

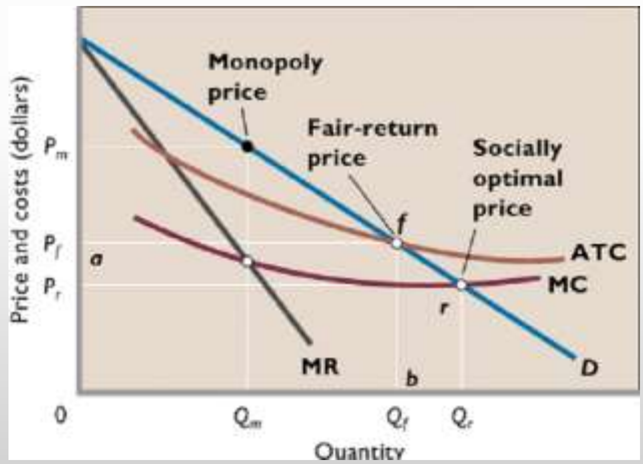
Monopoly

- What are the three definitions of monopoly
- Is the any such thing as a “monopoly price” as distinguished from the “market price”?
- What are some real-world examples of monopolies?
- What is the difference between the formation of a corporation, the merger of corporations, and the formation of a cartel?
- Do actions that increase profits result in a state more or less “just” than the previous state with less profits?
- Who is protected by anti-trust laws: consumers or competitors
  - Anticompetitive behavior and Tiger Woods: barriers to entry, predatory pricing, market power, tying, mergers & market share
- The Competition → Liberty Connection

Thinking Economically

A Closer Look at Monopolies

- P = Price
- Q = Quantity
- D = Demand
- MC = marginal cost
- ATC = Average total cost
- MR = Marginal revenue



Thinking Economically

Life, Liberty, and the Pursuit of Happiness – The Design of Government

- Collective goal of acting man is the pursuit of Happiness of all men – life and liberty are necessary to this pursuit and are its outcome
- Government → Liberty, not Libertine/Oppression: Men secure these rights when forming government; we don't give up, we gain
- Government should be designed to secure liberty, not diminish it
- Governors should lay down their lives for the governed, not benefit themselves
- Deterrence based on consequences, not coercion: before the fact (pre-market) or after the fact (post-market)?
  - Regulatory state: little need for penalties even after the fact
  - Civil justice system: civil torts after the fact
  - Criminal justice system: violent acts before and after the fact?: police, courts and jails
- Does the design of government today protect consumers or harm them? Protect liberty or diminish it?

Liberty and Labor

Consumers Rule: Voluntary Exchange and Prices
Thinking Economically Session 3a Study Guide

Required Reading:
What's It Worth? The Value of Things – Thinking Economically: Lesson 2 by Dr. Arthur B. Laffer
Government & Prosperity: Free Market Institutions – *Thinking Economically: Lesson 3* by Dr. Arthur B. Laffer
Consumer Sovereignty: What Mises Meant, by Robert Murphy

In addition, please read the excerpts below.

I. Life, Liberty & the Pursuit of Happiness
   a. Additional Quotes
      i. "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. — That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed." – Declaration of Independence
      ii. "IF man in the state of nature be so free, as has been said; if he be absolute lord of his own person and possessions, equal to the greatest, and subject to no body, why will he part with his freedom? why will he give up this empire, and subject himself to the dominion and controul of any other power? To which it is obvious to answer, that though in the state of nature he hath such a right, yet the enjoyment of it is very uncertain, and constantly exposed to the invasion of others" – John Locke, Chap. 9, *Second Treatise of Government*
      iii. "That a man be willing, when others are so too, as far-forth as for peace and defence of himself he shall think it necessary, to lay down this right to all things, and be contented with so much liberty against other men as he would allow other men against himself." – Thomas Hobbes, Chap. XIV, *Leviathan*
   b. Questions
      i. What is the purpose of government?
      ii. Do you agree with Locke and Hobbes that in the state of nature man is free, is the absolute lord of his own person and possessions, and has a right to all things? Why or why not?
      iii. What, if any, differences do you see between Locke's and Hobbes' ideas about the purpose of government and those expressed in the Declaration of Independence?
      iv. Does the fact that all men act, and act in their own perceived best interest, inform your thoughts about the purpose of government? If so, how?

v. Given your beliefs about the purpose of government, what should government look like? How does that purpose inform the design, actions, and character of government?

II. A Question of Value – Lesson 2

a. Additional Quotes

i. "For economics, the value of the particular ends we might choose is subjective. No one else can tell me whether an hour spent weight lifting is more or less valuable to me than one spent writing. Nor is there any possible way to objectively measure the difference in my valuation of these activities. No one has invented a "value-ometer." Expressions such as "That dinner was twice as good as last night's" are simply figures of speech. They don't imply an actual ability to measure satisfaction. As Murray Rothbard pointed out, the way to verify this is to ask, "Twice as much of what?" We don't even have a unit by which we might measure satisfaction. The subjective nature of value was one of Carl Menger's major insights. For the classical economists, value was a paradox. They attempted to base their theory of value on the labor involved in producing a good or the usefulness of the good, by some objective measure. But consider such a simple case as finding a diamond lying on the ground during a stroll. No labor was required to produce the diamond, nor is it more useful, at least to directly maintaining life, than a cup of water. And yet a diamond is generally considered much more valuable than a cup of water. Menger cut this Gordian knot by basing his theory of value on just that fact—things are valuable because acting humans consider them to be so." – Gene Callahan, Economics for Real People (p. 25)

ii. "The real price of everything, what everything really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What everything is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people. What is bought with money or with goods is purchased by labour, as much as what we acquire by the toil of our own body. That money or those goods indeed save us this toil. They contain the value of a certain quantity of labour which we exchange for what is supposed at the time to contain the value of an equal quantity. Labour was the first price, the original purchase-money that was paid for all things. It was not by gold or by silver, but by labour, that all the wealth of the world was originally purchased; and its value, to those who possess it, and who want to exchange it for some new productions, is precisely equal to the quantity of labour which it can enable them to purchase or command." Adam Smith, Wealth of Nations, Book I, Chap. V.

iii. "A use-value, or useful article, therefore, has value only because human labour in the abstract has been embodied or materialised in it. How, then, is the magnitude of this value to be measured? Plainly, by the quantity of the value-creating substance, the labour, contained in the article. The quantity of labour, however, is measured by its duration, and labour-time in its turn finds its standard in weeks, days, and hours. … Commodities, therefore, in which equal quantities of labour are embodied, or which can be produced in the same time, have the same value." – Karl Marx, Das Kapital, Volume 1, Part 1, Chapter 1, Commodities

iv. "In his lectures, furthermore, Smith had solved the value paradox neatly, in much the same way as had Hutcheson and other economists for centuries. Why is water so useful and yet so cheap, while a frippery like diamonds is so expensive? The difference, said Smith in his lectures, was their relative scarcity: 'It is only on account of the plenty of water that it is so cheap as to be got for the lifting, and on account of the scarcity of diamonds ... that they are so dear'. Furthermore, with different supply conditions, the value and price of a product would differ drastically. Thus Smith points out in his lectures that a rich merchant lost in the Arabian desert would value water very highly, and so its price would be very high. Similarly, if the quantity of diamonds could 'by industry ... be multiplied', the price of diamonds on the market would fall rapidly. But in the Wealth of Nations, for some bizarre reason, all this drops out and falls away. Suddenly, only ten or a dozen years after the lectures, Smith finds himself unable to solve the value paradox. In a famous passage in Book I, Chapter IV of Wealth. Smith sharply and hermetically separates and sunders utility from value and price, and never the twain shall meet: '*The word value... has two different meanings, and sometimes expresses the utility of some particular object, and sometimes the power of purchasing other goods which the possession of that object conveys. The one may be called value in use: the other, value in exchange. The things which have the greatest value in use have frequently little or no value in exchange; and on contrary, those which have the greatest value in exchange have frequently little or no value in use. Nothing is more useful than water; but it will purchase scarce any thing; scarce any thing can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it.'* And that is that. No mention of the solution of the value paradox by stressing relative scarcities. Indeed, 'scarcity'- that concept so fundamental and crucial to economic theory - plays virtually no role in the Wealth of Nations. And with scarcity gone as the solution to the value paradox, subjective utility virtually drops out of economics as well as does consumption and consumer demand." – Murray Rothbard, *Economic Thought Before Adam Smith*, pp. 449 (online version).

b. Discussion Questions
   i. What makes something valuable to you? How do you think that other consumers/producers value goods?
   ii. How does Laffer say that the value of something is determined? What about Karl Marx? Adam Smith? Who do you agree with? What do you think is the best way to explain the value of economic goods?
   iii. Do you value an economic good in isolation or relative to alternatives to that good? What are some of the alternatives to a Dell laptop loaded with Windows Vista and Office?
   iv. Explain the cost, or cost of production, theory of value.
   v. The labor theory of value is one version of the cost theory of value. Explain this theory.

vi. Who is most famous for his elaboration of the labor theory of value? Where did he derive much of his theory from?
vii. What was Adam Smith's theory of value? Why does Rothbard criticize it?
viii. What criticisms of the labor theory of value does Laffer present?
ix. Can you measure the value of a good? If so, how—do prices provide a good measure? If not, why not?

c. Decreasing Marginal Utility – Lesson 1
    i. Discussion Questions
        1. Explain the concepts of utility and marginal utility.
        2. Why would the marginal utility of some good diminish as the supply of the good increases?
        3. What does the concept mean in terms of the construction of a demand curve?

d. Increasing Marginal Costs– Lesson 1
    i. Discussion Questions
        1. Explain what "economies of scale" means?
        2. Explain the concept of increasing marginal costs.
        3. Given the increased efficiencies that come from economies of scale, how can marginal costs increase?
        4. What are the real world ramifications of the law of increasing marginal costs?
        5. If marginal costs didn't increase, what would a supply curve look like?

III. Voluntary Exchange and Consumer Sovereignty

a. Read "Do Free Markets Always Work? Now Let's Be Honest" in *Government & Prosperity: Free Market Institutions* – Thinking Economically: Lesson 3 by Dr. Arthur B. Laffer

b. Read Consumer Sovereignty: What Mises Meant, by Robert Murphy

c. Additional Quotes
    i. "Economics therefore concludes that the only basic principle by which a community or society can get by is the principle of productive work. The more economically productive is a community, the more it is able to sustain those individuals who occasionally resort to the principle of beg, borrow, or steal. Related to the principle of production, however, is the principle of free and voluntary exchange which is characteristically relevant to the social economy, in contrast to the isolated-man Crusoe economy. As we will see in Chapters III and IV, production in the modern social economy involves a highly developed system of specialization and division of labor, on the one hand, and free trade and exchange, on the other hand. In the present context it is correct to say that, in the social economy, free and voluntary exchange is as important a way of getting by as is production. This principle of getting by on production and voluntary exchange has been dubbed by the German sociologist Franz Oppenheimer as the economic means." – Milton M. Shapiro, Foundations of the Market Price System.

ii. “If we look back into history, two main modes of production can be discerned. One is the relatively primitive direct-use or self-subsistence mode of production, in which production is undertaken by people for their own direct satisfaction. The other mode is the market division of labor—based on production for the market, specialization, exchange and money—under which increasing numbers of people on the five continents have been living.” – Milton M. Shapiro, Foundations of the Market Price System.

iii. “To understand the market economy, we must remind ourselves that every activity is simply a voluntary exchange between two or more consenting parties. That’s why both parties to an exchange benefit—they wouldn’t have agreed to it otherwise! Now we see why it was important to stress the subjective or “mental” nature of economic value. If value were an objective, intrinsic property of goods—like the weight of a fruit, for example—then it would be impossible for both people in a transaction to come away happier. For example, if Joe trades away his apple for Maria’s orange, they can’t both walk away with a heavier fruit than they started with. However, both Maria and Joe may believe they have the better or tastier fruit. Since value is in the eye of the beholder, it is possible for Joe to consider himself better off after the trade, and the same for Maria. In other words, it is perfectly logical for Joe to consider the orange more valuable than the apple, and yet for Maria to believe the exact opposite. (Note that this wouldn’t be possible for characteristics such as height or color; if both people thought the other’s fruit were heavier, one of them would simply be mistaken.) That is why voluntary trade is so beneficial for humans: it allows people with “reverse valuations” to swap goods so that everyone is happier with the new arrangement compared to the original distribution of property.” – Art Laffer, Thinking Economically Lesson 2.

iv. “It can be seen that in the market economy, characterized by the production of goods and services for subsequent exchange by a common medium of exchange, both use and exchange values are a vital part of the economic process. For the ultimate users of goods and services, the consumers, the satisfaction arising from consumption is the source of value or utility. For producers, the goods and services devoted to production are meaningful only in terms of the money and its exchange value, which they expect to generate from the sale of their product. But the crucial point to remember in distinguishing between these two values is that the exchange value of any productive good tends to be connected with the use value that the consumers attach to its end product. The amount of money that consumers can be expected to allocate to various consumer goods and services is strongly influenced by their subjective preferences. It is this anticipated money inflow that provides the basis for arriving at an exchange value for goods and services devoted to production.” – Thomas C. Taylor, An Introduction to Austrian Economics

v. "The capitalists, the enterprisers, and the farmers are instrumental in the conduct of economic affairs. They are at the helm and steer the ship. But they are not free to shape its course. They are not supreme, they are steersmen only, bound to obey unconditionally the captain's orders. The captain is the consumer. … The real bosses [under capitalism] are the consumers. They, by their buying and by their abstention from buying, decide who should own the capital and run the plants. They determine what should be produced and in what quantity and quality. Their attitudes result either in profit or in loss for the enterpriser. They make poor men rich and rich men poor. They are no easy bosses. They are full of whims and fancies, changeable and unpredictable. They do not care a whit for past merit. As soon as something is offered to them that they like better or is cheaper, they desert their old purveyors." Ludwig von Mises

vi. The term "consumers' sovereignty" is a typical example of the abuse, in economics, of a term … appropriate only to the *political* realm and is thus an illustration of the dangers of the application of metaphors taken from other disciplines. "Sovereignty" is the quality of ultimate political power; it is the power resting on the use of violence. In a purely free society, each individual is sovereign over his own person and property, and it is therefore this self-sovereignty which obtains on the free market. No one is "sovereign" over anyone else's actions or exchanges. Since the consumers do not have the power to coerce producers into various occupations and work, the former are not "sovereign" over the latter. – Murray Rothbard

d. Discussion Questions
    i. Why do people exchange goods? What benefits have come to society because of this? Why?
    ii. What changes in production over time have led to the importance of exchange in society?
    iii. What societal institutions or rights are necessary before one can engage in market exchanges?
    iv. Are all market transactions voluntary? Explain.
    v. Explain the importance of the voluntary nature of market transactions. What benefits accrue to individuals and society because of voluntary exchange?
    vi. What is the connection between value and exchange? How can two people both be better off after a market transaction?
    vii. Mises himself adopted the term "consumer sovereignty" to describe the state of affairs he discusses above. What did he meant by this term?
    viii. Discuss the concept of consumer sovereignty in light of voluntary exchange in the marketplace.
    ix. What was Rothbard's opinion of the term? How did he criticize it?
    x. What do you think of it?
    xi. Can consumers be sovereign when dealing with multibillion dollar, multinational corporations? If so, how?

IV. Market Prices

a. Read "The Function of Market Prices" in *Government & Prosperity: Free Market Institutions* – *Thinking Economically: Lesson 3* by Dr. Arthur B. Laffer

b. Additional Quotes

    i. The price system solves the problem of scarcity, or attempts to. There are millions of people with a myriad of wants, changing constantly, disasters, emergencies, maturity, etc. How to find the allocation of land, capital, finances and labor to satisfy all these can be only adjusted for within the market system with prices used to calculate where to put the effort. Prices indicate in a community (a collection of individuals with wants and desires) what is the value of a marginal unit. It tells consumers what others are paying and gives some indication to producers what gain is to be made by producing those goods.

    ii. "In Chapter VIII, which ostensibly shows how the market determines prices, the analysis attempts to demonstrate that in reality it is not so much the "market" per se that establishes prices but rather it is the firm which sets them at all times. It is the firm that sets prices initially, and it is the firm that later adjusts prices (and quantities) in response to the market feedback of surplus or shortage. Even more significant, it is the firm, in its efforts to maximize profits (or minimize losses), that makes the price and quantity adjustments required to avoid disequilibria (surpluses, shortages), and thereby creates the market's tendency toward stability of output and prices. The implication is clear: If the market process is shaped by a force that inheres toward stability, then the alleged "instability" and "anarchy" so glibly blamed on the market must be located elsewhere, in non-market sources." Milton M. Shapiro, in the introduction to *Foundations of the Market-Price System*.

c. Discussion Questions

    i. What is the free market price of a good or service, according to Laffer?
    ii. What is the important job that prices have to do, according to Laffer?
    iii. Discuss scarcity in the context of prices.
    iv. Who sets the price in a free market?
    v. How do prices serve as signals?
    vi. What role do prices play in establishing stability?
    vii. What happens when the price is too high? Too low?
    viii. What calculations does a company make based on prices?
    ix. Why is profit important?
    x. What happens when a company experiences profit or loss based on the price it receives for its goods or services?
    xi. Do prices measure value? What can we say about the value of two goods after they have been exchanged in a market transaction?
    xii. Does the fact that firms set prices discredit the concept of consumer sovereignty?

Abundance (or Poverty)

Government Disruption of Markets and Abundance
Thinking Economically Session 3b Study Guide

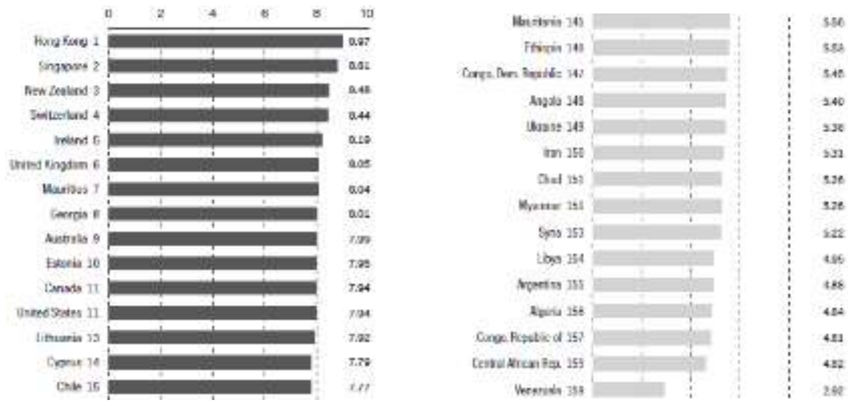
Required Reading:

A Labor Market Comparison: Why the Texas Model Supports Prosperity by Dr. Vance Ginn
Liberty or Economic Growth? Texas Can Have Both if We Rely on the Free Market by Bill Peacock
Entrepreneurs Versus Regulators: Government Intervention in the Market – Thinking Economically: Lesson 8 by Dr. Arthur B. Laffer
The Perfect as the Enemy of the Good: Market Failure or Market Opportunity? – Thinking Economically: Lesson 10 by Dr. Arthur B. Laffer
What is an Externality?, by Gene Callahan
A Critique of Neoclassical and Austrian Monopoly Theory, by Dominick T. Armentano
Monopoly and Competition: Chap. 10, Study Guide to Rothbard's *Man, Economy, and State*, pp. 121-134.
Let's Break Up Tiger Woods by Bill Peacock
What Has Government Done to Our Money? The "Proper" Supply of Money by Murray Rothbard
What Has Government Done to Our Money? Money Warehouses by Murray Rothbard
Defining Inflation by Frank Shostak
How the Business Cycle Happens, Murray Rothbard
Austrian Business Cycle Theory – Mises Wiki
Austrian Business Cycle Theory: A Brief Explanation - Dan Mahoney

Also, please read the excerpts in the outline below and review the study questions.

Discussion Outline:

I. Abundance
   a. In our first session, we discussed the question, "In a world of scarcity, how do we live "without our starving to death or killing one another in a barbaric struggle for survival?" Over the past three weeks, we've discovered the answer to that question: through voluntary exchange of private property through markets and through charity, under the protection of servant governors.
   b. Economic Freedom of the World



c. Economic Freedom and Government Spending in the U.S.

State	Economic Performance	Per capita Spending	Eco Devo Spending Rank	Adjusted Poverty Rank
Texas	1	$4,098	15	17
North Carolina	8	$4,417	12	28
Georgia	17	$4,258	5	45
Florida	18	$3,724	20	49
Virginia	19	$5,483	2	12
Top 20 Avg		$4,396	11	30
Bottom 25 Avg		$5,934	20	36
New York	26	$7,091	30	46
California	31	$6,452	11	50
Pennsylvania	38	$5,688	18	24
Illinois	46	$5,397	19	30
New Jersey	47	$6,095	27	37
Ohio	49	$5,389	13	36
Michigan	50	$5,429	21	31

d. Do government economic development program promote abundance or poverty? Liberty or oppression?

II. Market Failure and Consumer Protection: Perfect Competition, Monopolies, Unfair Prices, and Externalities

a. Consumer Protection

i. "Regulation displaces competition. Displacement is the purpose, indeed the definition, of regulation. Limitations on the number of taxicabs, licensing of barbers and dentists, health and safety codes, zoning laws, and price supports for milk depend on a belief that competitive markets should be replaced with something else." – Frank Easterbrook, "Antitrust and the Economics of Federalism."

ii. "Consumer-protection laws generally stand in stark contrast to the consumer-friendly workings of today's competitive markets, where the voluntary nature of markets forces attention to the needs and desires of consumers. They put the focus on the regulated industries, rather than on the consumer. Rate regulation, for instance, focuses almost exclusively on companies' profit levels. Measures to make competition "fair" focus on the impact of competitive activity on competitors. In neither case are consumers the focus of the regulators. The result is that consumer-protection measures generally seek to replace consumer preferences with those of the regulators and other intervening parties. This can't be helped—regulation, by its very nature, is intended to change the outcome of what would have otherwise happened through competition (i.e., the voluntary actions of buyers and sellers in the market)." – Bill Peacock, The Texas Homeowners Insurance Market Today

  iii. Why do people think consumers need protecting when they talk about consumer protection?
  iv. Who is it that should protect consumers?
  v. According to Easterbrook, what is the purpose of consumer protection laws and other regulations?

b. Market Failure
  i. Define market failure.
  ii. Give some examples of market failure.
  iii. What is the standard by which the results of the market are measured?
  iv. What is perfect competition? Does it exist?
  v. According to the model of perfect competition, is the entire real economy is an example of market failure?
  vi. Critics of capitalism claim that the fact that technology sits un-adopted on a shelf proves that capitalism unduly slows down the rate of technological improvement from what it could and should be, and call this a market failure that calls for government intervention. What do you think about this argument?
  vii. Do you think that market failure occurs?

c. Externalities
  i. What are externalities?
  ii. What are some common examples of externalities?
  iii. Examine the common notion externalities in light of Smith's invisible hand theory. Does it stand up under scrutiny?
  iv. What role does the concept of externalities play in supporting central planning or regulation taking?
  v. Does using central planning to replace market prices reduce or eliminate externalities and increase societal welfare? If so, what are some examples?
  vi. Are externalities caused by market failure, or by government failure?
  vii. Perhaps there are externalities caused by a lack of adequate understanding or technology to properly allocate costs. Which mechanism is best for correcting this problem as much as possible—the market or government?
  viii. Explain Callahan's take on externalities. Do you agree or disagree with him? Why?

d. Unfair Prices
  i. "Aristotle suggested a fallacious idea which many people now accept as gospel truth—the idea that the only fair exchange is an equal exchange, or, stated the other way around, that an equal exchange is the only fair exchange. This sounds reasonable, but it contains the seeds of many

fallacies concerning value, trade, and exchange. Nonetheless, this idea has been held by many people over the years. It is still held by millions of people today. It is responsible for a great deal of the feeling against profits and successful businessmen. It is generally felt that profits and business success are obtained only at the expense of workers or customers. In the popular mind it seems to follow, as night follows the day, that if someone else gains, someone else must have lost." – Percy L. Greaves Jr., *Understanding the Dollar Crisis*.

ii. What are the implications of the cost theory of value when it comes to fairness of a price?
iii. Is there actually such a thing as a fair or unfair price?
iv. For those who believe that there is such a thing, how do they determine what is fair or unfair? How do they explain the existence of fair or unfair prices in a free market?

e. Monopolies
    i. What are the three definitions of monopoly offered by Murphy in his study guide on Rothbard?
    ii. What critiques of each definition does he offer?
    iii. Why could everyone be considered a monopolist if the definition is a single seller of a good or service?
    iv. What is a monopoly price?
    v. Is the any such thing as a "monopoly price" as distinguished from the "market price"?
    vi. What do you think is the proper definition of a monopoly?
    vii. What are some real world examples of monopolies?
    viii. What is a cartel?
    ix. What is the difference between the formation of a corporation, the merger of corporations, and the formation of a cartel?
    x. How does Rothbard justify his argument that actions by a company or a cartel that increase profits result in a state more "just" than the previous state with less profits? What do you think of his argument?
    xi. What are anti-trust laws?
    xii. How is anticompetitive behavior defined? How is it tied to antitrust laws and monopoly theory?
    xiii. Thinking about the Tiger Woods piece, could one say that "anticompetitive behavior" is simply highly competitive behavior that is successfully beating the competition—even to the point of driving them out of business?
    xiv. What are price floors? What do critics say is wrong with pricing a product below its cost, i.e., predatory pricing?
    xv. Is predatory pricing harmful to anyone? Should it be illegal?
    xvi. What is market power? Where does the concept come from?
    xvii. Is there anything wrong with market power?

xviii. Should governments be concerned about the market share of corporations, their production and marketing practices, or their mergers or cooperation with other corporations?
xix. What is Armentano's take on monopolies and antitrust laws?
xx. Are anti-trust laws justified? In other words, do they really benefit consumers and increase competiveness? Or are they simply attempts by ineffective companies to reduce competition by eliminating successful competitive behavior by their competitors?

III. Government Failure: Who's Protecting Consumers Now?
  a. Additional Quote: Pareto efficiency, or Pareto optimality – Given a set of alternative allocations of goods or outcomes for a set of individuals, a change from one allocation to another that makes at least one individual better off without making any other individual worse off is called a "Pareto improvement." A state of "Pareto-optimal" or "Pareto efficient" is reached when no further Pareto improvements can be made. – Wikipedia
  b. Discussion Questions
    i. Many people hear about market failure then rush to the assumption that government is needed to repair the failure. Why do people assume that government can improve upon the operations of the market?
    ii. Laffer sets out some of the basics of his theory of government failure. Please comments on the following points in his discussion, the incentive they create—or don't create, and how they play a role in government failure versus market success:
      1. An entrepreneur receives funds through voluntary exchanges with customers, shareholders, or lenders. A government agency gets taxpayer funds from the legislature.
      2. An entrepreneur pockets the savings from his cost cutting, but a program manager would go to jail for doing the same thing.
      3. "We ought to run government like a business."
      4. Large corporations can use profit and loss accounting. Governments can't.
    iii. A big part of the theory of government failure is the knowledge problem. What is the knowledge problem, and how does it contribute to government failure.
    iv. Laffer finishes his discussion of the theory of government failure by writing, "The voluntary private arrangement … is replaced with a coercive arrangement …" Explain how this plays a role in government failure.
    v. Explain the concept of Pareto efficiency, or Pareto optimality. How can it be achieved?
    vi. What is the relationship of voluntary exchange and Pareto efficiency?
    vii. Does a voluntary exchange always achieve Pareto improvement?
    viii. Can Pareto efficiency be achieved through voluntary exchange?
    ix. What is government failure? What is it about government that would lead to failure?

x. Can government intervention bring about Pareto improvement or achieve Pareto optimality?
xi. What are the two main ways that the government recently has used in an attempt to stimulate economic growth?
xii. From what you have learned in this lesson, explain the problems with these government efforts to grow the economy.
xiii. What is the popular view of the relationship between consumer spending and economic growth?
xiv. What do you think is the origin of this view?
xv. How have we seen this view influence public policy in the last few years? Give specific examples of policies that have been implemented or proposed along these lines.
xvi. Laffer mentions some of the remedies or regulations that governments impose to combat these behaviors or the unfair prices that result from them. What are they? Can you think of others?
xvii. Price controls, such as price floors and price caps, are on example of government intervention in the market place. Laffer mentions two examples, minimum wages on labor and price caps on oil. What are some other examples in place today?
xviii. Laffer points to gas shortages of the 1970s and rent controls in major cities as examples of price controls imposed by government that cause problems for producers and consumers. Can you think of other price controls instituted by government entities (either domestically or internationally)? What were the results?
xix. What is the justification for price controls? Can the government, despite the challenge of government failure, overcome market failure to improve prices?

IV. Money and the Austrian Business Cycle

a. "According to Mises, Hayek, and Rothbard, the modern commercial banking system triggers the familiar boom-bust cycle when it floods the credit market with "excess" money. Suppose we have an economy that is originally in equilibrium, where the interest rate reflects the genuine amount of savings that private individuals are taking out of their incomes. Suddenly, the commercial banks decide to grant $100 million in new loans even though this new credit doesn't correspond to anyone's extra saving. (I describe the process here.) Because of the greater supply of credit, the market interest rate drops. This "false signal" leads entrepreneurs to borrow more funds and start longer projects than they otherwise would have. A false, unsustainable boom starts, giving most people an illusory sense of prosperity. Later on, when the banks become worried about rising price inflation, they will slow down or even reverse their injections of unbacked new money. The market interest rate will rise back toward its correct value, and many businesses will be caught with their pants down. They'll need to reduce output, or even shut down altogether. Workers and other resources will be released from those sectors that were stimulated the most during the boom. A general bust or recession sets in." Robert Murphy, from "Can Gold Cause the Boom-Bust Cycle?"

b. "It is important, first, to distinguish between business cycles and ordinary business fluctuations. We live necessarily in a society of continual and unending change, change that can never be precisely charted in advance. People try to forecast and anticipate changes as best they can, but such forecasting can never be reduced to an exact science. Entrepreneurs are in the business of forecasting changes on the market, both for conditions of demand and of supply. The more successful ones make profits pari passus with their accuracy of judgment, while the unsuccessful forecasters fall by the wayside. As a result, the successful entrepreneurs on the free market will be the ones most adept at anticipating future business conditions. Yet, the forecasting can never be perfect, and entrepreneurs will continue to differ in the success of their judgments. If this were not so, no profits or losses would ever be made in business. … The problem of the business cycle is one of general boom and depression; what we are trying to explain are general booms and busts in business. … The main problem that a theory of depression must explain is: why is there a sudden general cluster of business errors? This is the first question for any cycle theory. Business activity moves along nicely with most business firms making handsome profits. Suddenly, without warning, conditions change and the bulk of business firms are experiencing losses; they are suddenly revealed to have made grievous errors in forecasting." Murray Rothbard, *How the Business Cycle Happens*.

c. Definitions of Inflation
    i. "Inflation *is* the increase in the supply of money and credit." – Henry Hazlitt, *What You Should Know About Inflation*, 1960
    ii. "Undue expansion or increase of the currency of a country, esp. by the issuing of paper money not redeemable in specie." – American College Dictionary, 1960
    iii. "An abnormal increase in available currency or credit beyond the proportion of available goods resulting in a sharp and continuing rise in price levels." – The American Heritage Dictionary, 1968
    iv. "A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services." – Glencoe: Principles and Practices, Texas economics textbook, 2003
    v. "The rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling." – The American Heritage Dictionary, 2010

d. Discussion questions:
    i. How did we exchange goods before the advent of money?
    ii. What is money? Why is it better?
    iii. Explain the concept of money warehouses.
    iv. Explain the difference between a 100 percent reserve and fractional reserve banking system.

v. Could banks make money in a 100% reserve system? How?
vi. What are the problems with a fractional reserve system according to Rothbard?
vii. How do Hazlett and other Austrians define inflation?
viii. How has the definition of inflation shifted over time?
ix. Why might some people be motivated to define inflation as an increase in prices?
x. Man always chooses those production processes that can produce a _____ amount of output for consumption in the ______ amount of time.
xi. What is the difference between saving and hoarding?
xii. Explain the difference between business cycles and ordinary business fluctuations.
xiii. Entrepreneurs do not always accurately judge the time preference of consumers. But how does monetary inflation interfere with all entrepreneurs' understanding of shifts in consumer time preference? What is the result?
xiv. Give a general overview of the Austrian Business Cycle.
xv. How does the Austrian Business Cycle differ from the conventional explanation of business cycles?
xvi. Do you think that the swings in the economy that we see (e.g., the 1920s vs the 1930s; 1970s vs 1980s; 1990-92 vs. 1993-2001 vs. 2002-2007 vs. 2008-today) are caused by natural swings in the activity of business or because of government intervention?