

## CHAPTER 2

### APPROACHING THE MATERIAL

This chapter contains three fundamental ideas: transactions and the benefits of exchange, comparative costs and efficiency, and a quick introduction to economic institutions and modes of governance.

As for the first, I usually start this chapter in class by taking the suggestion on page 35 and attempting to elicit verbal "proofs" that a voluntary exchange benefits both parties. Sooner or later someone will mention alternatives, and with them opportunity cost and valuation. Extend this to the idea that if transaction costs are too high some exchanges will simply not take place, and that someone who figures out a way to cut those costs creates wealth.

Some reviewers have said that the material on comparative costs really doesn't belong here, since the course is not about international trade. I agree. That's why I start with persons and only later try using nations. I tell the class that understanding how the self-interested specializations of Jones and Smith bring about efficiency is arguably the most important thing they will ever learn, and that the only way to get to the bottom of it is to massively simplify. I emphasize it for the reasons first summarized by the late Paul Heyne in his *The Economic Way of Thinking*. Roughly, he acknowledged that the world has plenty of problems, but that the evaluation of schemes to ameliorate them first required an understanding of what the world looks like when it is functioning well. Jones and Smith are the world functioning well, and after they learn that it's time to bring on the problems.

Using two people at the start instead of two countries gets around the peripheral problems that apply to expositions of international issues – particularly exchange rates and income redistributions. The Ireland story abstracts from them too, but feel free to put in any other international considerations you might like. Just remember that time is short and this is not an international trade course. Can anyone out there put together a neat comparative advantage graphic example for the Bangalore material?

In this book, institutions and governance matter. Try to elicit other examples of institutions from your students. Then have them invent business relationships and transactions and classify them by mode(s) of governance. Prepare them for ideas about choice of governance mode by asking about the costs and benefits that would ensue if a transaction currently under one mode of governance (e.g. a contract for weekly deliveries of an input into production) were instead put under some other mode (making the input in a subsidiary of your own firm).

I recommend about two hours on the material. The first should go through the basics of exchange, transaction costs, etc. and start production efficiency. Spend most of the second on the production example, do Ireland and India if you have time, and then spend the final 10-15 minutes on institutions and governance. You can get away with this little time on them because they will keep coming up in subsequent chapters.

### Answers to End-of-Chapter Questions

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- 1a Barter requires a "double coincidence of wants," On the way home tonight I will want to buy some macaroons. In order to be more certain of making the transaction I will have to hold an assortment of goods that the macaroon baker might want in exchange for them (and I may still not hold the exact good she wants). Money solves the problem because each of us knows that money will be accepted by anyone we might want to deal with. I need hold only a relatively small amount of money for transactions, and can hold my other wealth in forms that I enjoy more or that give me a higher return. Money further reduces the problem of comparing prices by giving them a common denominator. (Take a sequence of barter possibilities: An A exchanges for so many B, a B for so many C, and on through Y exchanging for so many Z. How many Z does giving up a B get you? Isn't it easier if they are all priced in dollars?)
- 1b English reduces the cost of transacting for reasons that have some analogies to money. Negotiating in our own languages means we will have to find and pay someone who knows both languages if we are to write the deal. If we have a common language, even if it is not the one we usually speak, those costs are reduced.
- 2 There are several possible reasons. Purchase of an auto for most buyers is a relatively complex transaction, and the salesperson may provide helpful information to the customer while acting as agent for the dealership. Might it be better for a prospective buyer to lease the car instead? How much for your trade-in versus the price you pay on the car? What if the buyer wants a color that the dealer does not have in stock right now, but some other dealer might? What if a buyer won't pay the sticker price but will pay \$100 less, a difference that still yields the dealer an acceptable profit and the buyer the benefits of the new car? A fixed-price policy means that some of these transactions become impossible, and (judging from Saturn's experience) apparently does not provide a superior outcome for most customers and Saturn dealers.
- 3 This extends a question from Chapter 1 on opportunity cost. If you offer me \$100 for my faculty parking permit and I accept, we both feel better off. But when we play the roles of faculty and student, we are doing so to further the interests of others – for example, taxpayers who fund my salary and part of the cost of educating you. If you miss class, all that is lost is one student's experience at my lecture, but if I miss class because I could not find a parking space all 50 students in the class lose the lecture. If I pay you the \$100 I do not bear the full opportunity cost of my actions, which includes the losses to students who show up for class on days when I cannot find a parking space. You can change the question in a number of ways to make the point more clear. For example, If I get docked \$2,000 in pay every time I miss class, I probably won't be willing to settle for a price as low as \$100 to sell my parking permit.
- 4 Use the reasoning of Figure 2-2. If they somehow come about, lower transaction costs can benefit both the farmer and the buyer. With the figures given in the problem, it appears that the buyer bears much of the transaction cost necessary to compensate transporters, grocers, etc. If the farmer hauls the goods to town, he will only be better off if he gets a price that more than covers the cost of transporting them.

- 5 Production differs from theft because it increases economic value. Turning inputs into outputs makes both the producer and consumer better off than they would otherwise be. Theft means that something which once was mine is now yours, with no net benefits for the two of us. More likely, theft decreases the benefits from production and consumption that are available to the two of us. I must take some wealth I could otherwise have consumed or invested and use it instead to prevent you from stealing from me. Since I might just as well also be a potential thief you would also have to spend on protecting your property. Both of us are poorer than if theft did not exist as a problem.
- 6 The doctor profits from your illness, the teacher from your ignorance, the clergyman from your fears about eternity, the grocer from your hunger, etc. etc. What's nice about economics is that it allows us to think about the benefits to both sides of a transaction. I profit (gain better health) from medical services that raise my productivity, you benefit from the ability to purchase your teacher's knowledge, etc. etc.
- 7 If you have non-mainstream preferences, you are less likely to find a prospective partner in a small town than in a large city. In our terms, being in a city lowers your expected transaction costs of finding that person. Not surprisingly, sociologists find that residents of small towns are more strongly oriented toward durable families and conventional sex.
- 8 Their two production sets have identical slopes. Say each has marginal cost of  $1A = 1B$ . Then Jones cannot find a price at which to sell an A than makes him and Smith both better off than if they had not traded at all, likewise for B.
- 9 Try a graphic like this one:

