# Chapter 2: The One Lesson of Business

**Main Points**

* Voluntary transactions create wealth by moving assets from lower- to higher-valued uses.
* Anything that impedes the movement of assets to higher-valued uses, like taxes, subsidies, or price controls, destroys wealth.
* Inefficiency means that each asset is employed in its highest-valued use. Each inefficiency implies a money-making opportunity.
* The art of business consists of finding an asset in lower-valued use and devising ways to profitably move it to higher-valued one.
* A company can be thought of as a series of transactions. A well-designed organization rewards employees who identify and consummate profitable transactions or who stop unprofitable ones.

**Related Videos**

* [Video Lecture](https://www.youtube.com/watch?v=M_BqzXDXBGI): House buying moves assets to higher valued uses; Regulation Q is a price control and Euro dollars were invented to circumvent the control.
* [Stossel, Greedy Seniors](https://www.youtube.com/watch?v=KtI6ZVOzWqQ) Seniors consuming healthcare at alarming rate due to Medicare
* Stossel, [On Vanderbilt’s Greed](http://managerialecon.blogspot.com/2014/08/repost-stossel-on-vanderbilt.html); an economic perspective on the wealthy
* Stossel, [Poverty](https://www.youtube.com/watch?v=5VgfE0QYhF0) 7 minute video questioning whether foreign aid can cure poverty
* Stossel, [Outsourcing](https://www.youtube.com/watch?v=5HMjqQaWqes&feature=related) 6 minute video defending outsourcing
* Stossel, 7 minute video explains that the best way to save [endangered species](https://www.youtube.com/watch?v=OSPkVoGx5c4) is to eat them
* 4 minute Wall Street [Greed is God](https://www.youtube.com/watch?v=PF_iorX_MAw&feature=youtu.be) speech on how takeovers create value
* Would you [give up the Internet](https://www.youtube.com/watch?v=0FB0EhPM_M4) for 1 million dollars? Shows the gap between “worth” and “cost”

**In-class Problem**

Ask a student for an example of a price control, tax, or subsidy, and then ask them which assets end up in lower valued uses. Ask someone else if they can figure out a way to make money from the inefficiency? If you get no volunteers, ask someone to analyze the effects of the minimum wage. Do this without supply and demand; instead talk about the transactions that are deterred by the regulation (employers willing to hire at a wage below the minimum wage and those willing to work at below the minimum wage are deterred from transacting). Ask if there is a way to make money by consummating these transactions (outsourcing, start a temp agency, etc.).

**Additional Anecdote: Zimbabwe deters transactions**

Discuss the following article:

“Mugabe should heed the warnings of Hayek,” by Marian Tupy, *Financial Times*, Copyright 2005 The Financial Times Limited, Published: July 27 2005

Available online at <http://www.ft.com/cms/s/939cb766-fe3c-11d9-a289-00000e2511c8.html>

The article summarizes the negative economic consequences associated with the expropriation of private property of (white) commercial farmers in Zimbabwe in 2000.

**Teaching Note**

I often begin with a brief overview of “where have we been, where are we going, and how are we going to get there?” Students like this review, as it puts what we are doing into perspective. In this case, I remind them that in the first chapter we showed students how to align the incentives of individuals with the goals of an organization (give them enough information to make good decisions and the incentive to do so); in this chapter we show them how to identify profitable decisions.

We start out talking about how the wealth creating mechanism of capitalism is the movement of assets to higher valued uses, and that taxes, price controls, and subsidies slow down the movement of assets, or encourage assets to move in the wrong direction. I then remind them that decision making in firms can either move assets to higher valued uses, or not, and that the point of this lecture is to show them how to make profitable decisions by learning how to compute the benefits and costs of a decision.

The main point of this chapter is to introduce the metaphor that ties all the business problems together: Identifying assets in lower valued uses, and then figuring out how to profitably move them to higher valued uses. Get them thinking about how to use this metaphor to help identify problems (which assets are in lower valued uses) as well as how to solve them (how do we profitably move them to a higher valued use?).

I open this class by asking students how wealth is created (by moving assets to higher valued uses). If the student answers correctly, ask the respondent what he or she means by “value” (ability to pay). If you get another correct answer, confront the student by asking “do you mean that a poor student, growing up in poverty, does NOT value education?” (Yes, that is correct.). With executive MBA’s, you might want to ask students how they, or their company, create wealth. Relate it back to moving assets to higher valued uses.

The “one lesson of business” is to find assets in lower valued uses and find a way to profitably move them to a higher valued use. Alternatively, the lesson can be rephrased as seeking out unconsummated wealth creating transactions and finding ways to profitably consummate them. This theme will tie all the book chapters together.

Many students have taken a microeconomics class, so I then use a “compare and contrast” approach to explain how micro differs from managerial. Several points to reinforce:

* Economists are concerned with public policy; MBA’s with making money.
* Economics tools help you spot assets in lower valued uses and to design public policy to facilitate the movement of assets to higher valued uses. MBA’s use economics to spot assets in lower valued uses so they can buy them, and profitably move them to a higher valued use.
* Economists see inefficiency as something to be eliminated; MBA’s as something to be exploited. Elimination of inefficiency is a by-product of their effort to exploit it.

I illustrate the difference between micro and managerial by looking at the effects of three policies on marginal transactions: price controls (prevent some voluntary wealth creating transactions); taxes (deter movement of some assets to higher valued uses), and subsidies (move some assets to lower valued uses). Then, after you have identified assets in lower valued uses, ask what an economist would do (change policy) and what an MBA would do (buy the asset, and sell it to someone who valued it more highly.) I focus only on the “marginal” transactions that are affected by the policies.

You may also want to talk about the role of government in facilitating wealth-creating transactions. Compare and contrast countries like Zimbabwe with those of Hong Kong or the US (PJ O’Rourke’s book, *Eat the Rich*, is great on this account). The paradox is that there is more wealth-creating potential in countries like these because the government’s rules have put assets in lower valued uses, but the same government rules make it difficult to move them to higher valued uses.

I close the lecture by noting that organizations have trouble creating wealth for analogous reasons: internal taxes, subsidies, or price controls that impede the movement of assets to higher valued uses within the organization. Use an example, (My favorite is Phycor, a physician management company that purchased physician practices with stock. This practice reduced the incentive of physicians to work hard, essentially by turning owner/managers into stockholders of a larger entity), or refer back to the two stories in the first chapter.

**Additional Blog Posts and Articles**

* [ManagerialEcon.com (Chapter 2)](http://managerialecon.blogspot.com/search/label/02:%20The%20One%20Lesson%20of%20Business)
* Steven Landsburg, “The Iowa Car Crop,” *The Armchair Economist,* (New York: The Free Press, 1993) pp. 197-202.

This reading illustrates the idea that “voluntary transactions create wealth” by making the case for international trade.

* Steven Landsburg, “Why Taxes are Bad: The Logic of Efficiency,” *The Armchair Economist,* (New York: The Free Press, 1993) pp. 60-72.

This reading illustrates the concept of efficiency and shows how taxes cause inefficiency.

* Frédéric Bastiat, [“Candlemakers’ Petition.”](http://bastiat.org/en/petition.html) (http://bastiat.org/en/petition.html)

One of the most famous documents in the history of free-trade literature is [Bastiat](http://en.wikipedia.org/wiki/Bastiat)’s famous parody, in which he imagined the makers of candles and street lamps petitioning the French Chamber of Deputies for protection from a most dastardly foreign competitor, the sun.

* Milton Friedman, “The Social Responsibility of Business is to Increase its Profits,” *The New York Times Magazine*, (Sept. 13, 1970).

A clear articulation of what my colleagues in the Divinity School refer to as the “Andrew Carnegie Dichotomy,” a company should make as much money for its shareholders as possible in order to let them do “good” with the money, should they choose.

* Related Blog Posts:

- [Monkey Parking](http://managerialecon.blogspot.com/2014/06/moving-parking-spots-to-higher-valued.html)

- [McDonalds in Italy](http://managerialecon.blogspot.com/2013/05/what-my-daughter-is-learning-in-rome.html)

- [US Safety Net has Become Hammock](http://managerialecon.blogspot.com/2013/09/has-us-safety-net-become-hammock.html)

- [Book Review: Ethics and Public Policy](http://managerialecon.blogspot.com/2014/07/book-review-ethics-and-public-policy-by.html)

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