Texas Public Policy Foundation

WHAT'S IT WORTH?

The Value of Things

By Dr. Arthur B. Laffer

Thinking Economically

Lesson 2

Texas Public Policy
FOUNDATION

Thinking Economically

Thinking Economically

Key economic concepts at the foundation of our market-based economy, such as value, entrepreneurship, and competition, often get lost in today's complex policy debates. Too often this results in unforeseen consequences that no one involved intended to bring about.

Thinking Economically is a project of the Texas Public Policy Foundation designed to provide a basic economic education for policymakers, the media, and the general public. In this way, the Foundation hopes to highlight the intersection of economics and public policy, and the importance of "thinking economically" when making policy decisions. We are grateful to be able to undertake this project with the assistance of Dr. Arthur Laffer, who has throughout his distinguished career shaped the thinking of many world leaders by bringing sound economic thought into policy debates and the public's awareness.

Thinking Economically

In the late 1950s, the Ford Motor Company sank a reputed $400 million into the development of a new car line, the Ford Edsel. For two model years, cars with the unique Edsel grill design were produced. In the third and last model year, it had become so obvious the Edsel was a colossal flop that few Edsels were produced that year. The Edsel's value, as it turned out, was far less than the costs of its development and ongoing production.

For the Cabbage Patch doll, the story was very different. Introduced in mass-produced form in the early 1980s, the doll ignited a craze. Parents lined up for hours before stores with new doll shipments could open, anxious to "adopt" (buy) one of the dolls for their children. Once the doors opened, fights would sometimes break out and people were trampled in stampedes to grab the dolls. Some of the dolls were purchased by enterprising individuals who would take out an ad in the classifieds and command premium prices hundreds of times the original store price. Clearly for many, the value of the Cabbage Patch doll was much higher than the costs involved in producing and retailing them.

What made the Edsel so valueless and the Cabbage Patch doll so valuable? For that matter, why do the prices of plywood, batteries, and loaves of bread go up in coastal cities when hurricanes bear down on them? What lessons can policymakers derive from such phenomena? Economists have something to say in answer to these questions.

The Edsel is an example of how the value of a good or service is determined by human choice rather than by some intrinsic worth.

Value Is Determined By Human Choice

Market prices are set by supply and demand. But economists can say more than just this—they know that supply and demand are themselves determined by people's evaluations of the economic value of different goods. Even though objective realities such as resource supplies and technological know-how are important, in the final analysis even these objective realities are reflected in people's subjective view of their worth. Thus ultimately, these subjective views cause market prices to be what they are.

Oil didn't make land more valuable until people began to place more value on oil.

For example, if a superstitious culture erroneously believes that mandrake root possesses medicinal properties, then the root might command a very high price in the marketplace, even though it's not "really" valuable. On the other hand, land containing vast reservoirs of crude oil would have been relatively cheap in 1800, because people at that time didn't realize the uses to which oil would be put in the 20th century. Had they known, even back then the land's price would have been bid up. These two illustrations make clear that it is the expectations and actions of the consumers and producers that set market prices. Any "objective" condition can only influence prices indirectly when someone grasps the situation and alters his behavior accordingly.

Market Exchange Is a Win-Win Proposition

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.

Voluntary trade benefits everyone by allowing *all* parties to a transaction to be better off.

The Value of the Output Goods Determines the Value of the Inputs

We've seen that the individual, with desires and perception of reality, is the ultimate starting point for market prices. People can evaluate the usefulness (or "utility") of various goods to directly satisfy their objectives, and moreover they can evaluate the utility of additional units of a good. As we explained in Lesson 1, people don't choose between all the water and all the ice cream in one fell swoop. Rather, they choose a particular unit of water or a particular unit of ice cream—and this is why it's possible for ice cream to command a higher unit price, even though water is essential for survival.

Unlike water and ice cream, which are directly useful, there are other goods that are only indirectly useful. For example, it is entirely understandable why someone would trade away an orange for an apple; they're both nutritional, and perhaps the person just likes the taste of apples more or has eaten too many oranges already.

But why would a person be willing to trade away an orange for a handful of apple seeds? After all, you can't eat apple seeds (or at least, it's no fun to do so), and they're not particularly pleasing to the eye. So why give up a perfectly good orange for them?

The answer of course is that with enough time, soil, rainfall, etc., the directly useless seeds can produce the tasty apples. In a sense, the value of the apple is mentally transferred to the items that produce it. Here too, objective facts are only relevant if the people involved are aware of them. It is always subjective views and preferences that matter when people make exchanges.


It costs more to live in Manhattan than Austin because people value Manhattan more.

The Cost Theory of Value Is Wrong

We now see why the cost theory of value has it totally backwards. For example, suppose two cowboys visit New York City and go to a restaurant on Broadway. Looking over the menu, the first exclaims, "Ten dollars for a bowl of chili?! How can they charge prices like that?!" The second cowboy, employing the cost theory of value, explains, "Well the owners have to charge that much. Just imagine what the monthly rent is for this place, and how much they have to pay the waitresses and cooks!"

The cowboy's explanation sounds reasonable enough, but upon reflection it's not a very compelling theory of market prices. For one thing, there's nothing to single out Manhattan versus Austin in his story. Why aren't property rents and wage rates higher in Austin than in Manhattan, causing chili to be more expensive in Austin diners? Our cowboy hasn't really explained anything at all; he's just pushed the problem back one step, from high chili prices to high real estate and labor prices.

The problem with the cost theory of value is that "costs" are really just themselves prices. It's certainly true that any particular business can't stay in operation unless it charges enough on its products to "cover costs," but for economists the task is to come up with a general theory that can explain all prices. Our cowboy simply assumed all of the other prices with no explanation, and then drew conclusions about the particular price of chili in the Manhattan restaurant. This approach may have satisfied his buddy, but it won't do for economists or policymakers who need to really understand the big picture.

So what then is a better answer? It falls right from our discussion in the previous section. People first value those goods (and services) that directly cater to their desires, and then use these evaluations to determine the relative importance of those goods (and services) that in turn can produce the first batch of items.

Why would a particular woman be willing to pay $10 for a bowl of chili in the Manhattan restaurant? The immediate answer is, "Because she obviously valued that particular bowl of chili more than the $10 she gave up for it." Perhaps the circumstances are that she just attended a performance of *Cats,* and was starving after the show. Although a much cheaper bowl of chili was available a few miles away, maybe her stomach was grumbling and she didn't want to wait that long before eating.

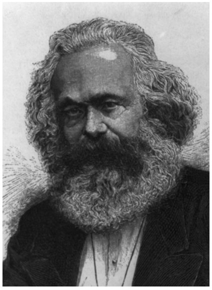
Later on in this lesson we'll explore some of the subtleties of the analysis. Of course the costs of production matter when trying to understand the structure of market prices. But it's crucial to realize that subjective preference must always fit into the story.

Other things being equal, more people want to live in Manhattan than in Austin. Thus they are willing to pay more for chili and, say, apartment units in Manhattan than in Austin. When confronted with the scarcity of resources, their demands push up chili prices and apartment rents, which in turn cause real estate prices and ultimately wage rates in Manhattan to rise above the levels in Austin.

Switching contexts might drive the point home. In the grand scheme, gold mines are more valuable than silver mines because consumers prefer gold rings to silver rings. Although it costs about as much to actually mine gold as it does silver, the price of gold is greater than the price of silver because consumers prefer gold rings to silver rings. It is not true that gold rings are more expensive than silver rings because it "costs more" to use gold. That may very well be how a jeweler interprets the situation, but such a simplistic explanation begs the question of why gold costs more than silver, and not vice versa.

The Labor Theory of Value Is Wrong

A particular (and very popular!) version of the cost theory of value is the labor theory of value. This was the approach of Karl Marx, but he actually adopted it from the British classical economists. Basically, the labor theory says that the only "real" sacrifice involved in production is human toil; Mother Nature doesn't charge hu-



Marx's labor theory of value is wrong, but continues to have a strong influence on economic thought today.

Photo source: Library of Congress Prints and Photographs Division mans to use her resources. Therefore, the "fair" price of something corresponds to how much total labor went into it.

Beyond the more scholarly writings of the 19th century economists and even Marx himself, the labor theory of value survives to this day in the form of conventional views about fair prices. People often expect to be paid more for something because they worked so long on it. Many a professor has heard a student complain about a test grade, "But I studied so hard for this test!"

The truth is, how much effort someone puts into a project does not automatically translate into the quality of the finished product. Even if he has a cold and is bored, Paul McCartney can put on a better musical performance than any economist we know. For a more extreme example, if someone spends days preparing a literal mud pie, it will still taste awful and no one will pay a cent for it.

The reason people fall for the labor theory of value is that market prices in the real world really do seem to go hand in hand with how much effort is needed to produce something. A hand-stitched afghan is more expensive than a blanket mass-produced in a factory. But what's really happening is that consumers subjectively value the hand-made items more than the goods cranked out of an assembly line (because of delicate workmanship, the novelty, etc.), and in order to induce laborers to spend the time making them, the final price is bid up to a relatively high level. At the same time, if it were not possible to get a higher payment for the hand-stitched afghan, craftspeople may not be willing to produce them by hand. Again, confronted by a scarcity of hand-stitched afghans in comparison to the mass-produced factory blankets, demand pushes up the prices for afghan blankets.

Value is in the eye of the beholder.

How the Free Market Price Is Determined

In Lesson 1 we explained why demand curves fall and supply curves rise. To recap, demand curves fall because consumers will only purchase additional amounts of a good or service at lower and lower prices. This is because of the principle of diminishing marginal utility, meaning that consumers get a smaller and smaller "kick" as they consume more and more of a specific good.

Supply curves, on the other hand, rise because producers need to be offered higher and higher prices in order to produce greater amounts of a good or service. This is because of the principle of rising marginal costs, meaning that at some point it becomes increasingly difficult to crank out incremental amounts of a good.

The free market price is quite simply the one at which supply and demand are balanced. At any price, producers want to sell a certain number of units, and at the market price consumers want to purchase the exact number of units producers want to sell. There is no force pushing the price higher or lower—because consumers and producers are perfectly matched—and this is why economists sometimes call it the "equilibrium" price.

What happens if the price (for some reason) is higher than this market-clearing level? Well, remember that a higher price means producers want to increase the amount they bring to market for sale, while at the same time a higher price induces consumers to cut back on their purchases. So if we start at a point of balance and then the price moves higher, we know that producers will try to sell more units than consumers will buy. A surplus or glut then exists, with inventories building up and products sitting on store shelves. Producers quickly slash prices in order to move the unsold stocks, thus pushing the system back toward equilibrium.

An opposite reaction occurs if the price is below the market-clearing level. In this case, consumers try to buy more units than producers will sell. Disappointed customers are turned away with nothing, even though they would've been happy to pay the advertised price. Producers realize the opportunity and raise prices accordingly, moving the system back toward the equilibrium price.

In the real world, preferences, resource supplies, and technologies are always changing, so the equilibrium price actually moves around constantly. In a market where prices are allowed to move freely, the system always moves swiftly toward the new equilibrium point. Stores don't acquire vast stockpiles of goods that no one wants to buy, and consumers aren't constantly frustrated by the inability to buy goods at advertised prices. Mistakes occur, of course, but the profit and loss system ensures that they are infrequent and rectified as quickly as possible—there's money on the line!

When the Government Interferes With Prices, Bad Things Happen

Market prices aren't arbitrary; they convey the relative scarcity of goods and services. People need accurate market prices in order to make proper production and purchasing decisions. When well-meaning policymakers interfere with the price system, they distort the economy and often harm the very groups they intended to help. The two main ways that government meddles in this way are price ceilings and price floors.

When the government imposes a price ceiling, it threatens (with fines or sometimes worse) to punish anyone caught charging more than the legally permissible price for a certain product or service. The ostensible purpose of a price ceiling is to keep important items affordable, by prohibiting the "outrageous" price hikes that would occur in an unregulated market. In other words, the government uses its power to artificially keep the price below the market-clearing level.

From our analysis above, we know that at the market price, supply and demand perfectly balance. So when the government pushes the price lower through its threats of fines, consumers want to buy more units of the product than producers want to sell. A shortage results. When prices are allowed to freely fluctuate, shortages are quickly eliminated. But when the government is responsible, shortages can persist indefinitely.

There are countless examples of government-imposed shortages. For example, many Americans remember the long lines at gas pumps in the 1970s. They probably think this was caused solely by OPEC when oil supplies were severely curtailed. But on the contrary, the long lines and rationing schemes were due to the price controls on gasoline imposed by Washington. The moment the price controls were lifted, the lines disappeared. People had to pay an unusually high amount for gasoline, no doubt about it; but at least they could get it.

Another example of a price ceiling is rent control in major cities. Here the government tries to help lower-income tenants by placing legal maximums on what their supposedly greedy landlords can charge. The consequence? There are long waiting lists to get into the coveted apartment units. "Slumlords" can stay in business, even though they don't fix the water heater or put on a new coat of paint every season. Since the government artificially

Some people blamed OPEC, but the long gasoline lines of the 1970s were caused by U.S. price controls.
Photo source: Library of Congress Prints and Photographs Division

cuts into their revenues, owners of apartment buildings have to cut corners somewhere. Even the government can't change the fact that people get what they pay for. When the politicians artificially lower how much is being paid, the quality predictably suffers. And keep in mind that a price ceiling does not just tell producers that they cannot charge (or receive) more than the maximum price; it also means consumers cannot pay more than the maximum, even if they would willingly do so.

Things are just as bad when the government imposes a price floor. By forcing the price above the market-clearing level, the government creates a surplus. Producers keep churning out more units of the good than the consumers want to buy. The best example of a price floor is the minimum wage. At $5.15 per hour, laborers may want to work a lot of hours. But at that rate, employers don't want to purchase that many man-hours of labor. The consequence is unemployment, particularly in neighborhoods with many low-skilled workers. If a particular

Price floors reduce the competitive forces that lower prices on consumer goods.

teenager has never held a job before and has no skills, he or she might be worth only $3 an hour when first hired—and willing to work at that price as well. By insisting that this worker be paid more than double that (when you consider Social Security and other compliance costs beyond just the paycheck), the employer will quite obviously decide to skip over this worker. And thus the minimum wage law keeps the most vulnerable workers from getting their foot in the door and becoming more productive.

Price floors are also imposed to combat "predatory" pricing, when a producer sells a product below cost to gain market share at the expense of competitors. The fear is that once a producer succeeds in driving its competitors out of business, it will have a monopoly and be able to raise prices to harm consumers. Of course, this never happens in reality.

Instead, consumers are for a while greatly benefitted through lower cost goods or services. And it is very unlikely in this age of highly liquid capital that producers could drive all of their competitors out of business. But even if they could, as soon as prices began to rise, consumers would start switching to substitute products, and entrepreneurs would rapidly respond to the new opportunity for profit by investing in the industry. The producer that had cut its prices would find it very difficult to sustain price levels high enough or long enough to make up for its former losses, much less to make a profit! Consumers, and the economy, would be the beneficiaries.

Free to Choose

We should remind ourselves that beyond the economic analysis of unintended consequences, there is the important point that market prices are an expression of the voluntary choices of individuals. When policymakers complain about certain prices being too high or too low, they are really criticizing the decisions of men and women to dispose of their own property as they see fit. If Joe wants to trade away his apple for Maria's orange, who are the policymakers to second guess them? And if Joe wants to trade away an hour of his labor for three of Maria's dollar bills, again we must ask, who are we to judge? ◆

Thinking Economically

About the Author

Arthur B. Laffer is the founder and chairman of Laffer Associates, an economic research and consulting firm that provides global investment-research services to institutional asset managers, pension funds, financial institutions, and corporations. Since its inception in 1979, the firm's research has focused on the interconnecting macroeconomic, political, and demographic changes affecting global financial markets.

Dr. Laffer has been widely acknowledged for his economic achievements. His economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction as the "Father of Supply-Side Economics." He was also noted in *TIME's* 1999 cover story on the "Century's Greatest Minds" for inventing the Laffer Curve, which it deemed one of "a few of the advances that powered this extraordinary century." His creation of the Laffer Curve was deemed a "memorable event" in financial history by the *Institutional Investor* in its July 1992 Silver Anniversary issue, "The Heroes, Villains, Triumphs, Failures and Other Memorable Events."

Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981-1989).

Thinking Economically

Texas Public Policy
FOUNDATION

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of individual liberty, personal responsibility, private property rights, free markets, and limited government.

The Foundation's mission is to improve Texas by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policymakers, the media, and general public.

Funded by hundreds of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

900 Congress Ave., Ste. 400
Austin, Texas 78701
Phone 512.472.2700, Fax 512.472.2728
info@TexasPolicy.com
TEXASPOLICY.COM