2. THE ONE LESSON OF BUSINESS

Capitalism & Wealth
Do Mergers Move Assets to Higher-Valued Uses?
Does the Government Create Wealth?
Economics versus Business
Wealth Creation in Organizations

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.
- The art of business consists of identifying assets in low-valued uses and devising ways to profitably move them to higher-valued ones.
- 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.

~~Supplementary Material~~

~~ManagerialEcon.com (Chapter 2)~~

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

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

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~~Example of how taxes destroy wealth; but they also create opportunities for those know how to evade them~~

~~A [Massachusetts] lawmaker who voted to hike the state sales and alcohol taxes was spotted brazenly piling booze in his car - adorned with his State House license plate - in the parking lot of a tax-free New Hampshire liquor store~~

~~Short Videos:~~

~~7-minute video : The One Lesson of Business~~

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~~The first is an animated lecture by Froeb; and the second is a famous scene of a vulture capitalist addressing a shareholders' meeting of a company considering his offer to buy up the company and liquidate it.~~

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

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Teaching Note

A common teaching tip is to ~~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, as it puts what we are doing into perspective. In this case, ~~I~~ remind them 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 s~~Start out talking about 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 t~~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 o~~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 they mean 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, and then I 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~~ i~~llustrate 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 f~~Focus only on the "marginal" transactions that are affected by the policies.

Instructors ~~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 c~~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, and this 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.

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.).

Supplementary Material

Blog Entries

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ManagerialEcon.com (Chapter 2)

Auxiliary Slides

Larry the Liquidator Speech to the Shareholders from "Other People's Money"

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Gordon Gecko's 'Greed is Good' speech from Wall Street

ReasonTV's "Gas Lines, Gouging, and Huricane Sandy

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Readings

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Additional Anecdote: Zimbabwe

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.