Choice and Cost under Uncertainty

The 3rd Meeting
Law and Economics

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Uncertainty, Evolution and Econ Theory

Armen Alchian (1914-): The year before the H-bomb was successfully created [in the 1950s], we in the economics division at RAND were curious as to what the essential metal was—lithium, beryllium, thorium, or some other. The engineers and physicists wouldn't tell us economists, quite properly, given the security restrictions. So I told them I would find out. I read the U.S. Department of Commerce Year Book to see which firms made which of the possible ingredients. For the last six months of the year prior to the successful test of the bomb, I traced the stock prices of those firms. I used no inside information. Lo and behold! One firm's stock prices rose, as best I can recall, from about $2 or $3 per share in August to about $13 per share in December. It was the Lithium Corp. of America. In January, I wrote and circulated within RAND a memorandum titled "The Stock Market Speaks." Two days later I was told to withdraw it. The bomb was tested successfully in February, and thereafter the stock price stabilized.
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• Did business people “really” use marginal productivity and profit-maximization analysis in making decisions?
• Richard Lester, “no.” Fritz Machlup, “yes.”
• What would you say?
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- Armen Alchian, “It's not what you think you are doing or how you rationalize your choice of that action. It's whether the action has survival value. And if outside analysts can identify the reasons the chosen action had survival value, and in what direction changes in the environment (constraints) affect survival conditions, economists don't have to worry about how people discover by thought or luck what are the new best conditions. Competitive trial and error will evolve toward the fittest -- whom economists characterize as profit maximizers."
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• Examples
  – Gas station
  – Irrationality
  – Basket ball
  – Raising children
  – Development strategy / Photocopy of Constitution
  – Commercial success
  – Behavioral economics
  – The mean of market price is to be defined, rather than to be revealed, by numerous individual transactions
Cost

1. The cost of an event is the highest-valued opportunity necessarily forsaken.
2. Only if no alternatives were possible or if all resources were plenty, so that all goods were free, would the concept of cost and of choice be irrelevant.
Cost

3. The distinction between (a) undesirable attributes inherent in some event and (b) the highest-valued forsaken option. Only the latter is cost as the term is used in economics.

4. What the more intense pain does is *reduce the value of the swimming pool, not raise its cost*.

5. A uniform reduction in the value of all options reflects the lower level of “utility” now generally available.
Cost

6. The use of money prices does not mean that people love money. It means simply that money is the medium of exchange and therefore is the convenient symbol of interpersonal exchange values of events or options. (e.g. the so called “materialism”)

7. The cost of the use of any resource is never less than the highest-valued opportunity for its use; it is always equal to the amount bid by the most optimistic (highest) bidders in the market for that resource.
Cost

8. A person who buys a car now incurs a cost, but by borrowing he can shift the reduction in consumption to the future.

9. The distinction between (a) private cost and (b) public cost.

10. The extent of divergence between private and public costs depends on the technology and on the legal structure of property rights.
Cost

11. A golf course builder could buy enough land to build a course and to build homes on the surrounding property, thus internalizing a higher value from proximity to the golf course.

12. Shopping center. Gain by free parking?


14. Another example of quarry. The landlord never fishes even though there is a large pond.
Cost

15. The distinction between (a) burning a neighboring restaurant and (b) reducing the economic value of the restaurant by attracting customers away from that restaurant.

16. Everything that could be done before I opened my restaurant still can be done. The dollar amount you scarifies is a measure of a transfer of wealth from you to two other parties, me and the customers. Property rights protects physical attributes, not economic value.

17. Dead Weight Cost (无谓损失) vs. Transfer. (e.g., the reason theft is bad? The effects of alcohol legalization.)
Rent

1. The payment for a resource where the availability of the resource is insensitive to the size of the payment received for its use is name “economic rent” or “quasi-rent.”

2. When two separately owned resources are so specific to each other that their joint rent exceeds the sum of what each would receive if not used together, then that joint rent to the pair was called “composite quasi-rent.”
Rent

3. The joint value might become the object of attempted expropriation by one of the parties, especially by the one owning the resource with controllable flow of high alternative-use value.

4. Preventative arrangements, such as ownership, a firm to own both, hostages and bonding, regulation, etc. (e.g., (1) who should be the boss? The one with firm specific assets, such as most investors. (2) the hold-up in marriage.)
Rent

5. High rents a result, not cause, of high price, which is in turn, a result, not cause, of demand and supply for the end-user product. It is the S&D for the end-user product that define the price of the inputs of production, not the other way around.

6. The salary of super star; the price of meat; the price of a good car; the sale of a bike with unnecessary bells and whistles.
See you next meeting!