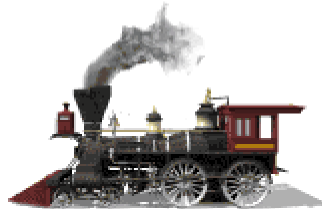
Fundamental Economic Concepts

Tuesday, June 22, 2010 by Jason Riddle

Where do prices come from? What is money? What is interest? What is the market? Understanding the Fundamental Economic Concepts is the essential first step to understanding the real impact of human decisions. Below is a list of 12 essential economic concepts everyone should know.



"*Economics is haunted by more fallacies than any other study known to man.*" - **Henry Hazlitt, Economics in One Lesson**

"It is no crime to be ignorant of economics, which is, after all, a specialized discipline and one that most people consider to be a 'dismal science.' But it is totally irresponsible to have a loud and vociferous opinion on economic subjects while remaining in this state of ignorance." **- Murray Rothbard**

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1. Scarcity and Subjective Individual Value

The world in which we exist is composed of scarce resources that can be used to satisfy our virtually limitless needs, wants, and desires; more specifically the world is composed of ***scare resources with alternative uses***.

Human preferences and circumstances vary greatly. Individuals assign a particular value to an available resource through a process of individual thought. The concept of value apart from an individual living being is not possible. Because the concept of value applies only in relation to individual preference toward specific available resources at a specific point in time, ***value is subjective*** in this regard.

For example, a person in the desert may value a cold beverage differently than a person at home on the coach who just finished drinking a large glass of lemonade.

- *Note:* As explained by Murray Rothbard, the use of the term *subjective value* must not be confused as negating validity of the *objectivity of value* when applied to other economic concepts such as purchasing power and market price. Also, subjective value must not be confused with the **objective value system** in the philosophical study of ethics. These concepts are all compatible with one another.

Goods are items existing in scarce quantity that have subjective value to an individual. An apple or a dump truck might be a good. An element in a far off universe that has yet to be discovered is not a good.

2. Production, Time Preference, and the Cost of Foregone Alternatives

Goods possessing value to the individual do not occur abundantly in nature and cannot be consumed without first being produced, created, harvested, etc. through a very specific process. ***Goods of value must first be produced*** through individual thought and individual action before they can be made available for consumption. In short, life is the process of purposeful, self-sustaining action to produce things of value for consumption.

Because individuals must act in order to obtain goods of value, it logically follows that present goods, as a rule, are always preferable to otherwise identical goods in the future. This is the ***law of time preference***.

- *Note:* The law of time preference is an essential fact of the human condition that is necessary in the explanations of many economic concepts. Time preference, however, is often forgotten or ignored by mainstream economists leading to necessarily false conclusions.

Human desires are virtually limitless, but resources, including our time, are limited to finite quantities. For this reason, individual humans must each decide how to best allocate their time and available resources to obtain the goods they subjectively value. Since it is impossible to

satisfy all of our desires instantaneously, every action we pursue in order to obtain something of value has a cost associated with it; the ***cost of the foregone alternatives***.

The popular economic expression used to explain the ***cost of foregone alternatives*** (or ***opportunity costs***) is, "there is no such thing as a free lunch." Even if someone else pays for your meal, the cost associated with the lunch is actually the value of the next best alternative you could have been enjoying instead. One individual cannot build a house, go to the mall, eat dinner, harvest crops, and watch a movie all at the same time. We have to choose what we value most based on individual preference and available resources.

The fundamental question, surrounding production of goods is not whether or not to produce, but rather how efforts are best directed to achieve the most desired values for consumption.

3. Incentives and Margin - Two Keys to Understanding Human Decision Making

Incentives matter. We decide how to use our limited time and limited resources based on what we *believe* will most satisfy our needs, desires, and preferences. Regardless of whether or not we realize it, humans are constantly making countless economic calculations to rank values in terms of subjectively determined costs and benefits. This is the basic process that drives all voluntary human action; from ordering a pizza, to watching a play, to reading a blog. Economics is the science of human decision making – the science of purposeful human action.

Above we described how items do not and cannot have value apart from an individual's subjective valuation. It is important to remember that specific items have specific value to a specific individual at a specific point in time.

Since we know that we value goods as specific units in relation to our needs and desires, we can see why we don't have to make sweeping 'all or nothing' decisions. We don't have to choose between, say all the hamburgers in the world or all the lemonade in the world. The extent to which an individual subjectively values a particular good is ***defined at the margin***. This means the value of a single unit of a particular good is determined by the value of the good's least preferred use. An explanation similar to the one presented by Thomas Taylor in an **Introduction to Austrian Economics** may help:

- Let's say I have ten gallons of water at my house. I might want to use two for drinking, three for cooking, four for watering the flowers, and one for making water balloons. To me, the value of my tenth gallon of water is equal to an arsenal of water balloons. If I was making a trip through the desert with ten gallons of water, I might value the water for drink over the enjoyment of a water balloon fight.
- Similarly, if I have ten gallons of water at my house with the same preferred uses as above and encounter a man selling delicious hamburgers for the bargain price of one hamburger for one gallon of water, I may very well be willing to make a trade. My cost for giving up my tenth gallon of water is the cost of the foregone alternative: the water balloons. It might even make sense for me to give up a few gallons of water depending how much my flowers

> need to be watered and how tasty his burgers are. In the desert scenario, depending on the length of my journey and the status of my supplies, exchanging a few gallons of water for hamburgers may be the difference between life and death.

This is an extreme example, but it shows that all individual human decision makers perform a cost benefit analysis at the margin.

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4. Consumer Goods, Capital Goods, and Savings

The goal of all production is to make or obtain goods of value for consumption. Goods produced by an individual directly for consumption are referred to as ***consumer goods***. Goods that are used as part of an individual's plan to produce a consumer good are referred to as ***capital (or production) goods***. Like consumption goods, capital goods do not appear in nature in effortless abundance. They must be produced. Since every action incurs the cost of foregone alternatives, effort spent in producing consumer goods cannot be spent producing capital goods. Effort spent producing capital goods cannot be spent producing consumer goods. Therefore, for an individual to continue to enjoy a desired level of present consumption without disruption, the individual must amass a certain value of real savings in order to invest in the formation of capital goods. ***Savings*** is the exchange of present consumption for consumption in the future. Capital investment requires real savings; either a postponement of current consumption or a consumption saved goods.

The classic deserted island scenario depicts a survivor initially surviving on berries (consumer goods). Most all of the survivor's waking time is spent picking and eating berries. Eventually, the survivor decides to increase output or decrease berry consumption in hopes of generating enough real savings to last a few days. Once the savings level is sufficient to satisfy his need for berries, the survivor takes time off of picking berries and uses his mind and his effort to build a harvesting tool (capital good). After the tool is built, the survivor now only needs half a day to satisfy his consumption needs and uses the other half of the day to build hunting tools. The process continues. His standard of living is increased by the creation of capital goods, made possible by real savings.

This example shows that there is a difference between producing for consumption and producing for capital formation. Real savings is a requirement for investment in capital production. All other things equal, it is not possible to increase consumption and increase investment in capital production with a finite pool of resources. The magicians in Washington **disagree**.

5. Property

We are only concerned about economics because we live in a world of scarce resources with alternative competing uses. If we had an infinite supple of resources to fulfill our every want and

desire without constraint, the problem of deciding how to best allocate goods and services of value would simply not exist. However, our resources (including our time and our physical bodies) are scarce, and they do have alternative competing uses.

As Hans-Hermann Hoppe details in the **Economics and Ethics of Private Property**, the very fact that we are able to argue at all *"...implies there is a conflict over the use of some scarce resources, otherwise there would be no need for discussion. This is only possible because of objective boarders of **property** - borders which anyone can recognize as such on his own without having to agree first with anyone else with respect to his system of values and evaluations."* Hoppe goes on to explain:*"The fact of being alive presupposes the right to property. No one who is alive could argue otherwise."*

While, the question of who should have the right to property (nature of ***property rights***) is a question for **Political Philosophy**, there are significant economic implications as well.

Ludwig von Mises's **calculation argument** states that economic calculation (the cost-benefit analysis of anticipated resource applications in terms of a common denominator) is literally impossible without private property. Because *no private property* necessarily implies *no market prices* for land, labor, and resources; no market prices means expected revenue and cost cannot be expressed in common terms. The absence of a common expression for calculating exchange relationships means accounting operations and economic calculations are impossible! No private property, no economy. It's that simple.

Mises elaborates:

- "*Without economic calculation there can be no economy. Hence, in a socialist state wherein the pursuit of economic calculation is impossible, there can be--in our sense of the term--no economy whatsoever. In trivial and secondary matters rational conduct might still be possible, but in general it would be impossible to speak of rational production any more."*

Socialism is unworkable in theory and in practice for the unavoidable reason that economic calculation is not possible in the absence of private property. **Private property is the first theory of sound economics.** It is no coincidence that the strongest economies in the world are those that have historically protected individual's rights to private property.

Additional Suggested Readings*:*

Economic Calculation In The Socialist Commonwealth by Ludwig von Mises
The Economics and Ethics of Private Property by Hans-Hermann Hoppe

6. The Market

One of the most misunderstood economic concepts is that of the "market". We hear the terms "free market" and "controlled market", but what are we referring to by the ***market***?

The ***market*** is a complex process of events caused by individuals acting purposefully; based on independent subjective valuations. The market is a process of constant change brought about by the choices and actions of individual humans. It is neither a static *thing,* nor is it an aggregation of homogeneous ingredients or broad generalities.

Change in the market is constant. The very essence of every human action is change. As individuals act, their subsequent actions (including their valuations) change. For this reason, **Thomas Taylor** notes, "...the dynamic market process should be examined; not the static condition of equilibrium."

So, the term "free market" means nothing more than a process of events in which interacting humans are uninhibited from acting purposefully based on their independent subjective valuations. In any uncoerced exchange between humans (i.e. humans interacting in an unhampered market), both individuals exchange the goods and services they view as less important for goods and services they view as more important for their needs. Based on their subjective valuations, they are both better off.

A "controlled market" or "market intervention" refers to economies where forces outside of the naturally occurring market interfere with the choices and actions of individual human actors. But can coercive market intervention ever satisfy the needs and wants of consumers more than a free market of individual human actors?

Murray Rothbard explains:

- "*[The] view [that free-market action must be brought back into optimality by corrective State action] completely misconceives the way in which economic science asserts that free-market action is ever optimal. It is optimal, not from the standpoint of the personal ethical view of an economist, but from the standpoint of the free, voluntary actions of all participants and in satisfying the freely expressed needs of the consumers.* ***Government interference, therefore, will necessarily and always move away from such an optimum.***"

7. Division of Labor and the Benefits of Exchange - Specialization and Knowledge Sharing

Understanding the concept of ***comparative advantage*** is one of the keys to understanding economics. Most people (including those that make economic public policy for our country) do not understand this essential concept. Comparative advantage is the fundamental concept driving all economic transactions and forms the basis for human society. Division of labor and the benefits of exchange are among the primary reasons humans choose to live together and interact in society. Enormous benefits are realized through specialization and division of labor.

- "[The Law of Comparative Advantage] is the most important idea in the history of social analysis....This law -- a law like gravity, not a law like the speed limit -- is a description of why people cooperate and the ubiquity of the conditions that lead to this cooperation."

Jeffrey Tucker, **Cooperation: How a Free Market Benefits Everyone**

Comparative advantage may be best understood by thinking of the concept in terms of "low cost advantage". Here's a quick example:

- Even if Murray is stronger, smarter, and more productive than Paul in every way, it is still mutually beneficial for both people to engage in trade. Let's say Murray has the ability to produce 20 hamburgers and 40 glasses of lemonade in a day. Paul has the ability to produce only 5 hamburgers and 20 glasses of lemonade in a day.
- The relative cost for Murray to produce a hamburger is 2 glasses of lemonade (40 divided by 20) while the relative cost for Paul to produce a hamburger is 4 glasses of lemonade (20 divided by 5). Remember, costs are measured by the alternatives you have to give up in order to obtain a particular good.
- If Murray devotes more time to specializing in the production of hamburgers (his low cost advantage) and Paul specializes in production of lemonade (his low cost advantage), the two can then trade to mutual benefit. In fact, using the above scenario, if Murray devotes an extra hour a day to producing hamburgers instead of lemonade, and Paul devotes all of his time to specializing in the production lemonade, they are actually able to produce 10 more glasses of lemonade than if they remained in isolation without specialization and trade.

In our example above, Murray and Paul actually increase their total sum productivity by specializing and trading (note that their productive capabilities and technology was held constant). In economies of free free exchange, because of comparative advantage (low cost advantage), trade is beneficial and advantageous to both parties.

Division of labor and free exchange is the path to increasing wealth in a society because of the law of comparative advantage. In a system of free exchange, neither party is exploited and both parties benefit. This system is especially advantageous to members of society that are less skilled, less capable, and/or "underprivileged" in absolute terms. Because of trade, they are able to obtain and enjoy goods and services that otherwise would have never been possible to them.

It is for this reason that nations that protect property rights and permit individuals to engage in relatively free exchange are infinitely more wealthy than those the do not respect property rights or allow individuals to exchange freely. Property rights and freedom to exchange (freedom from coercive control) are two keys to reducing if not eliminating poverty. Most everywhere that poverty exists in the world, it can be directly linked to forcefully government intervention in these two areas. Poverty is an economic problem caused by brutal, exploitative politics.

Additional Suggested Reading:

Cooperation: How a Free Market Benefits Everyone - Jeffrey Tucker provides a great illustrative explanation of comparative advantage in this article**.**

I, Pencil by Leonard E. Read...If you don't do anything else today, read this article!!!

Economics and Knowledge by F.A. Hayek

8. Prices

The ***price*** on the market for any particular resource emerges as producers and consumers compete for the resource's alternative uses – i.e. what has to be given up in order to obtain a scarce good for its highest subjectively valued use. It is important to remember the market is a complex series of events caused by the purposeful action of individual humans. It is not correct to say the market "sets" a price for goods. The very essence of every human action is change. As individuals act, their subsequent actions (including their valuations) change. For this reason ***prices*** refer to the price of a specific resource at that specific time based on the subjective valuations of the buyer and the seller.

Because individuals in the market are competing for scarce resources with alternative uses, prices emerging on the market provide vital information about the relative scarcity, surplus, and consumer demand for resources. It is only through the voluntary interactions of individuals participating in the market process that the relative importance for resources is determined and allocated based on the subjective preferences of consumers and producers.

- *"...every time some small adjustment in the allocation of resources had to be made—go explicitly through all the relations between ends and means which might possibly be affected...In any small change he will have to consider only these quantitative indices (or "values") in which all the relevant information is concentrated; and, by adjusting the quantities one by one, he can appropriately rearrange his dispositions without having to solve the whole puzzle...this problem can be solved, and in fact is being solved, by the price system....Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to coordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan."* - **F.A. Hayek - "The Use of Knowledge in Society"**

Prices can be artificially set and enforced by coercive central planning / regulatory agencies. Regardless of the well meaning intentions of central planners, artificial price controls deviating from the market price (such as minimum wage laws and rent controls) always moves away from the subjective preference of consumers in the market. Resources are diverted away from their highest and best use and the result is always a net loss to an economy. One group may benefit from the government-granted special privilege, but only at the expense of the group that did not receive such privilege.

Artificial price control necessarily interferes with the essential role of prices in an economy (providing information regarding the relative subjective preferences of buyers and sellers in the market). The concepts of price and private property are inextricably linked. As **Lew Rockwell** notes, *"...prices simply cannot do their work apart from private property and concomitant freedom to contract."*

Private property is a prerequisite for market prices. Market prices are the way buyers and sellers communicate knowledge and information regarding the preferred uses of scarce resources. Not only is coercive price control a violation of property rights, but as explained in the Property section above, economic calculation is not possible without private property and prices.

- “*[Prices] are the exchange ratios of various goods, which result from the voluntary interactions of distinct individuals based on the institution of private property. Without the institution of private property, the information conveyed by prices simply does not exist. Private property is the necessary condition—die Bedingung der Möglichkeit—of the knowledge communicated through prices.*” **- Hans-Hermann Hoppe**

9. Money

Money originates in the free market. There is no other way it could have come about. Just because the king's and ruler's faces appear on money, people tend to think that money originated with the State. This is false. Money is not the invention of a king, government, or any other central planner. Money always exists as a valuable good in an economy before it is monopolized and used as a tool for expropriation by the ruling class.

- “*He who controls the money supply of a nation controls the nation”* - James A. Garfield

What is money and how does it originate?
Money is a commodity. The only difference between money and any other commodity is that money is demanded as a medium of exchange. Money must be a directly serviceable good before it is used indirectly as a medium of exchange. In barter economies throughout history, people noticed that certain commodities (e.g. gold, silver, salt) tended to be more marketable than others because they were widely excepted for purposes of indirect exchange. It is difficult to trade a cow for eggs, but this problem is eased by trading in terms of a widely accepted good such as salt. Once a commodity is universally accepted as a medium of exchange it becomes money. Because money is universally accepted it provides a common unit with which to express different quantities of different goods and enables economic calculation.

How does money get its value?
According to Mises's regression theorem, as explained by Bob Murphy in **The Origin of Money and Its Value**, the purchasing power of money today is caused by its expected purchasing power tomorrow based on knowledge of its purchasing power yesterday.

Is money the root of all evil?
See the full text of Francisco d'Anconia's **Money Speech** for the most rousing explanation of the nature of money ever penned.

"If you ask me to name the proudest distinction of Americans, I would choose--because it contains all the others--the fact that they were the people who created the phrase 'to make money.' No other language or nation had ever used these words before; men had always thought of wealth as a static quantity--to be seized, begged, inherited, shared, looted or obtained as a favor. Americans were the first to understand that wealth has to be created. The words 'to make money' hold the essence of

human morality.”

Additional Suggested Reading:
What Has Government Done To Our Money - Murray Rothbard - This is an excellent account of the origin of money, the history of the dollar, and a step by step explanation of how governments have systematically destroyed the purchasing power of money to expropriate wealth from its citizens.

The Origin of Money and Its Value - Robert Murphy - *"The importance of the Austrian school of economics is nowhere better demonstrated than in the area of monetary theory. It is in this realm that the simplifying assumptions of mainstream economic theory wreak the most havoc."*

10. Interest

Interest is an economic concept pertinent to any scenario where present goods are exchanged for future goods. All things being equal, humans subjectively value present goods more than a claim to identical goods in the future. It is this subjective individual time preference that explains interest. Interest is the difference between the monetary value of future goods and the monetary value of present goods. Correspondingly, the interest rate reflects the ratio of the monetary value of present goods to the monetary value of future goods.

The market rate of interest is essentially the aggregate of all the individual time preference rates of the market participants. It is the vital signal that coordinates the time preferences of consumers, producers, savers, and investors. The market interest rate indicates the amount of resources that may be devoted to the production of capital goods without frustrating current consumption based on available savings. Because capital investment requires foregoing current consumption, the interest rate signals to entrepreneurs the availability of real savings accumulated to undertake capital investment projects. In short, the interest rate is a measure of the market's preference of present goods in relation to future goods.

Two good essays for additional reference:
Böhm-Bawerk’s Critique of the Exploitation Theory of Interest - Robert Murphy
Why Do Capitalist Earn Interest Income? - Robert Murphy

11. Capital and the Structure of Production

Every economic exchange is an exchange involving property. Since money is a medium of exchange that enables economic calculation, money is a measure of the amount of total property available for production. Printing pieces of paper does not bring more property available for production into existence.

Thomas Taylor points out in an **Introduction to Austrian Economics**:

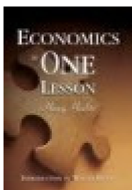
- *"What is important to understand is that the capital in a society is not a vague notion to be calculated as a total amount, rather capital goods are parts in an interlocking structure of individual plans."*
- *"The essential difference between rich societies and poor societies does not stem from any greater effort the former devote to work, nor even from any greater technological knowledge the former hold. Instead it arises mainly from the fact that rich nations possess a more extensive network of capital goods wisely invested from an entrepreneurial standpoint. These goods consist of machines, tools, computers, buildings, semi-manufactured goods, software, etc., and they exist due to prior savings of the nation's citizens. In other words, comparatively rich societies possess more wealth because they have more time accumulated in the form of capital goods, which places them closer in time to the achievement of much more valuable goals."*

Capital is not homogeneous and that capital exists only as part of an individual's plan. Another important concept to understand is the time structure of production. The capital structure broadens and lengthens in an economy similar to a formation of a coral reef. It is a process that requires time, and it requires saved capital.

If you haven't done so already, read **I, Pencil** by Leonard E. Read before you go on. Read's **I, Pencil** was referenced above in the section about ***Specialization and Knowledge***, but this short essay is also a great illustration about how lengthening the structure of production benefits an economy.

For an easy to understand illustration of capital formation and the structure of production, please see Robert Murphy's article from mises.org titled the **Importance of Capital Theory**. Robert Murphy situates the lesson humorously on an island where sushi production is the sole function of the economy. Paul Krugman lands on the island and tries to 'help' fuel the economy by introducing interventionist policy to increase demand. What results is an excellent lesson on capital theory.

12. Economics in One Lesson



To combat both a political system that grants privilege to special interest groups and man's tendency to see only the immediate effects of policy on these special groups, Henry Hazlitt presents us with a single, powerful **lesson**:

- "*The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups.*"

In part two of **Economics in One Lesson**, Hazlitt illustrates his lesson by using real world examples to demonstrate the harmful consequences of twenty-four common, logically flawed economic beliefs.

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