Name ____________________________________

THE FREE MARKET AT WORK (from *New Ideas from Dead Economists* by Todd Buchholz 1990)

Let us start with our self-interested neighbor John...While reading the newspaper, John admires the lovely wood sculpture of a vulture that hangs above his dining room table, as if ready to swoop down on table scraps. John really enjoyed carving the vulture. An idea strikes him: Why not sculpt more vultures and sell them? After all, the specially treated wood imported from Tasmania would only cost $50 per vulture, and he can sculpt one per week. He decides to sell the vultures for $200 each, since big profits could make him rich and bring him the things he dreams of, like big cars and riotous vacations in Acapulco. Most important though, he loves sculpting.

He begins working and rents a shop, inviting neighbors and local art critics to a gala opening. They laugh. He cries. They think the vulture sculptures are hideous. He cries louder. No one buys. Finally, his mother offers $49 for one. He gives in – and goes out of business….Why?

Instead of producing something his neighbors wanted, John produced what he wanted. Instead of charging a price they were willing to pay, John charged an exorbitant amount. But in John's case, no one would pay him as much as it actually cost him to produce the vultures. Didn't John have to charge more than his costs? No. The answer is not to charge more, but not to produce at all! Why should the invisible hand approve of John going out of business? To make the sculptures, John used up scarce resources. The earth only gives us so much to work with. If John used the valuable Tasmanian wood, no one else could. The invisible hand forces people to give up if they do not produce something more valuable than what they started with. John took $50 worth of wood, carved it up, and gave the world vultures worth less. Societies cannot afford to squander resources by subtracting from their value. People who take wood and produce Stradivarius violins or crutches for the disabled increase the value of those resources and enrich society. They deserve applause from the invisible hand. John deserved a punch.

Back to the drawing board for John. He pours a cup of tea, curses the vulture above his dining room table, and slams his fist down. Tea jumps out of the cup onto the table. Now he curses himself for spilling tea on the new table he made just a month ago. Inspiration strikes again. Why not, he asks, build tables and sell them? A bit wiser now, he finds a lumber mill that will supply wood to him at a cost of about $100 per table. Carving, planning, and fitting will take about two weeks per table. His time, he figures, is worth $200 per week, based on his previous job as a carpenter. Taking into account tools, rent, and other incidentals, he calculates the total cost per table at roughly $575. John window-shops for similar dining room tables and discovers he could sell the tables for $585. Not only will he be able to pay himself $200 per week but he will also earn a profit.

The invisible hand finally gives John a thumbs up. He's taken scarce resources and brought forth something more valuable than what he started with – not according to his own tastes but according to society's.

So far we have seen the invisible hand encourage and discourage production. But Adam Smith also shows us how the market regulates prices. Remember that Smith's characters are self-interested. Why does John not raise his table prices above $585 to increase profits? He cannot. If John boosts his prices, profits will plunge, because people will simply bypass his shop and buy from competitors who charge less. Of course, all the furniture-makers could get together and agree to raise prices. But even if they were able to agree, other self-interested people would see the high profits in the furniture business and open shops. Such entrepreneurs could earn enormous profits by underselling and stealing business away from the cartel.

Prices and profits signal to entrepreneurs what to produce and what price to charge. High prices and high profits sound alarms in the ears of entrepreneurs, screaming at them to start producing a certain good. Low profits or losses grab the businessman by the shirt collar and shake him mercilessly until he stops producing.

Prices and profits are not simply abstractions, though. What does it really mean if profits are high? It means that people need or want a product. If consumers decide they like compact disc players more than record players, demand will rise for discs, and producers will charge more. But record player manufacturers will respond to the signals by producing fewer record players and more disc players; workers will be shifted from one factory to another; and the price will return to normal. Over the past decade prices for personal computers and compact disc players have dropped, not only because costs have dropped, but also because so many high-technology manufacturers have entered the competition for profits. In the long run no industry should earn more than a normal profit. The free market automatically induces self-interested Johns to satisfy strangers. No central planner need call, no taskmaster need coerce.

Answer the following questions:

1. Why is John clearly "wasting" valuable scarce resources with his first plan? ____________________________________

____

____

____

2. Why does the invisible hand approve of John's table production?____________________________________

____

____

____

3. Explain what high profits really signal in a market. ________

____

____

4. What was the role of a central planner (government) in this article? ____________________________________

____

Name ___________________________________