

Is government action the best solution to cooperation in large groups?

- A. Yes, generally
 - B. No, generally
 - C. It depends
-
- Think about why or why not. What does it depend on? Why did you vote the way you did?

Review: the problem of Collective Action

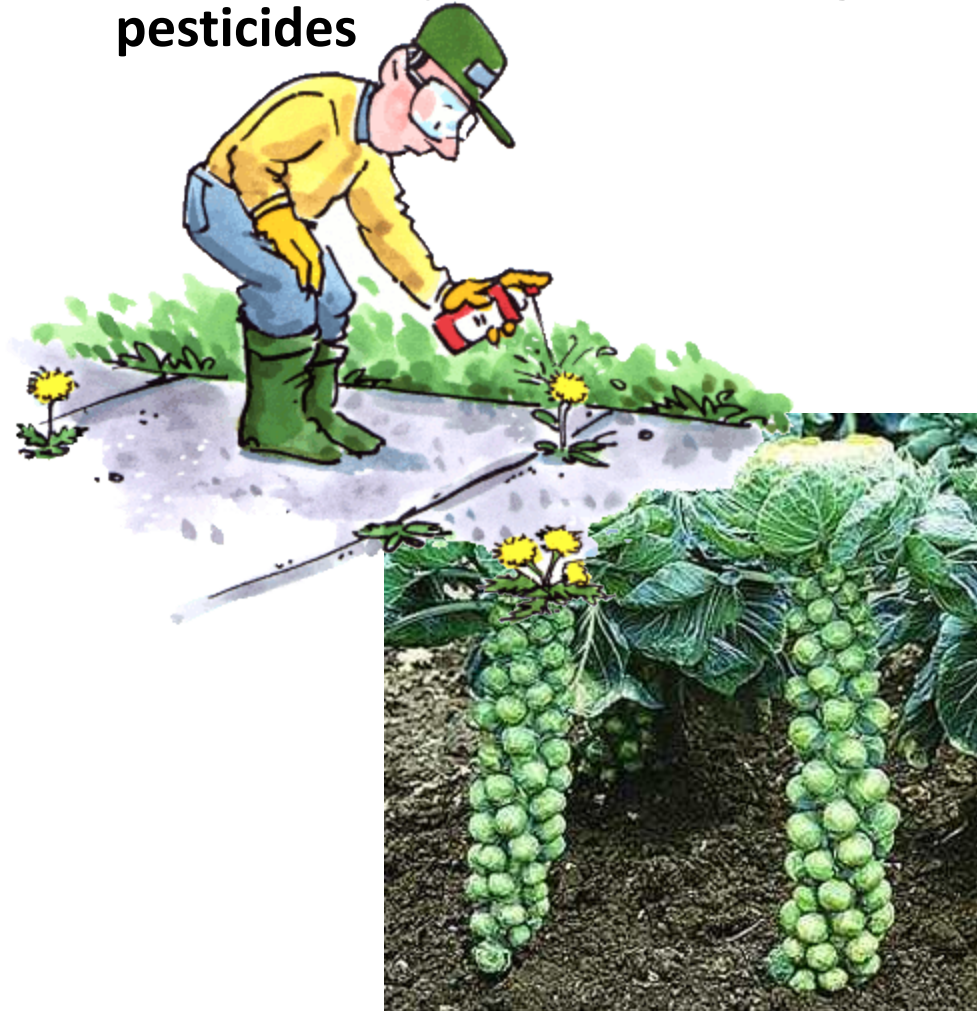
- Why not cooperate?
 - Explained by Game Theory: Rational, self-interested people prefer to go it along rather than cooperate
 - Which supports Liberal Economics view of freedom, rationality, self-interest and reliance on competition
- Why cooperate?
 - Market Failures: 1)markets need regulation to reduce corruption, 2) markets don't produce public goods
- What are public goods: Goods that are non-excludable and non-rival
- How to solve the problem of market failure and achieve cooperation in society: Government intervention? Laws and technical monopolies
- Economic Liberals prefer the Coase Theorem

An economic liberal's answer to the collective action problem: Coase Theorem



Who should win the lawsuit?

A. Brussels Sprouts Farm using pesticides



B. Herb Farm that wants organic certification



What would the Coase theorem say?



Free Trade and Comparative Advantage



Specialization + Trade

Get out your clickers! Assume you are an American....

- Which world would you prefer to live in:
- A. a world in which every American is 25 per cent wealthier than he/she is now, but every Chinese Indian, and Brazilian is much wealthier than the average American.
- B. A world in which Americans are only 10 per cent wealthier than now but way ahead of the average Chinese, Indian, or Brazilian?

Why Free Trade?

In any event, we cannot prosper by trying to impoverish our neighbours. A nation is more likely to grow rich from trade if its trading partners are also rich, industrious, commercial nations, than if they are poor.

- *--Adam Smith*

David Ricardo (1772-1823) and the corn laws (1815-1846)



Production without specialization and division of labor

| | Wine | Cloth | Total |
|----------------------|------------------------|-------|-------|
| England | 3 | 5 | 8 |
| Portugal | 9 (Absolute Advantage) | 6 | 15 |
| Total goods produced | | | 23 |

Opportunity costs

The “lost opportunity” of doing A is the value of any benefit given up by not doing B



A certain good should always be produced in the country which has the lowest opportunity cost



If a country can choose between producing two goods it should choose the one where it is most **EFFICIENT**

Production with specialization before trade

| | Wine | Cloth | Total |
|----------------------|------|-------|-------|
| England | 1 | 10 | 11 |
| Portugal | 16 | 0 | 16 |
| Total goods produced | | | 27 |

*Before trade: Resources put where they are most **efficient** (specialization)*

*Note: **Efficiency** increases total number of goods available, from 23 to 27*

Production with specialization and trade

*England trades Portugal 4 units of cloth for 4 units of wine
Exchange rate is 1 to 1.*

| | Wine | Cloth | Total |
|-----------------------------|-------------|--------------|--------------|
| England | 5 | 6 | 11 |
| Portugal | 12 | 4 | 16 |
| Total goods produced | | | 27 |

Total goods produced is still 27 but each country is better off than before trade and both are better off than before “efficiency”

**Without
specialization
and trade:**

| | Wine | Cloth | Total |
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**With
specialization
and trade:**

| | Wine | Cloth | Total |
|-----------------------------|-------------|--------------|--------------|
| England | 5 | 6 | 11 |
| Portugal | 12 | 4 | 16 |
| Total goods produced | | | 27 |

Two important principles

- 1) Efficiency produces wealth
- 2) Trade is necessary to be efficient, because through competition among producers, all countries grow = there is an absolute gain

Why we all should drive Toyota!



Assumptions of Ricardo's Theory

- Assumes static givens in a country's economy ...
- ... and doesn't discuss technology as a factor of production.
- Labor theory of value
- What?



Labor Theory of Value



Hechscher-Ohlin-Samuelson modernizes Ricardo and Smith

- Not labor, but a bundle of things: capital, labor, resources, management, and technology give a country a comparative advantage.
- It's factor proportions that count!