Notes 2. Value; Trade creates value; Middlemen

A. Value
A pound of tin is worth more than a pound of turnips. How come? That question, i.e., what determines the value of a good, is one economic thinkers have spent a lot of time and effort attempting to answer. The issue is pretty well settled today, but it’s instructive to take a brief look at the history of the theory of value. Adam Smith and David Ricardo, and practically all the early classical economists, ascribed to some form of the labor theory of value, which holds that the value of a good is determined by the amount of labor required to produce it, that is, the amount of labor that the good “contains.” Now, if you don’t take this too far, it works as a nice approximation of the real world. Writing in 1776, Smith put it in Wealth of Nations.

If among a nation of hunters . . . it usually costs twice the labour to kill a beaver which it costs to kill a deer, one beaver should naturally exchange for or be worth two deer.

Now, assuming that the hunters are rational, utility-maximizing individuals, who won’t waste their time hunting animals that won’t bring a price high enough to justify the effort—which also assumes that these guys have a pretty good idea of the relative market prices of different animals and other goods, too—this makes sense. A beaver pelt must be worth two deer skins because it trades for two of them. I won’t mind spending twice as much time for each beaver I trap if I know that each beaver pelt will sell for as much as two deer skins. But a big problem with the labor theory of value arose when economists reversed the causality: If I spend twice as much time hunting a beaver as you do hunting a deer, then my beaver pelt must be worth two of your deer skins. Wrong! Say that it also takes twice as much time to kill a rat as a deer. (Rats make a small target and can be pretty hard to shoot. Try it some time.) Does that mean that one rat pelt will trade for two deer skins? Not likely. But doesn’t the rat pelt “contain” twice as much labor as the deer skin? Yes, but who cares? It’s still a rat pelt. Who wants it?

That gets to the heart of modern value theory, which is based on something developed in the 1870s called marginal utility theory, which you’ll get familiar with in Economics II. The basic idea is that the value of a good depends on the usefulness, or utility, it produces for the consumer. The modern concept was best stated by the American (University of Chicago) economist Frank Knight in 1928:

[C]ost must be measured in terms of products, and not of pains or outlays.

That is, I don’t care how much trouble it was for you to make that widget, I’m only going to pay you what I think it’s worth. So in modern thinking, value is subjective, that is, it is determined by the person (subject) doing the valuation, not by any quality of the good (object) itself. In contrast, the labor theory of value is objective; the value rests in the object itself. A simple test shows the problem of the labor theory of value and the wisdom of the modern subjective theory. Consider a box of crackers that you have produced and I consider buying. If the value of the crackers is objective and is equal to the amount of labor they contain, then you will value them at, say, $1. But if value really is objective, then I will value them at $1, too. So, what’s the lowest price you will take for the crackers? Assuming that you won’t make a trade without making yourself better off (see section B, the Principle of Voluntary Exchange), that’s $1.01. But if I won’t make a trade without getting a gain, too, then I won’t pay any price higher than 99 cents. And neither will anyone else. Since the value of the crackers is objective, it’s the same for everyone. Hmm. Looks like you’ll have to eat the crackers yourself.

Of course, this isn’t how the world works. People make trades all the time, which implies that the seller places a lower value on the good than the buyer in every trade, which implies that value must be . . . subjective.

(Historical note: Karl Marx developed his economic and political theories based on a variant—one might say a mutant—form of the

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2 Frank H. Knight, “A Suggestion for Simplifying the Statement of the General Theory of Price,” Journal of Political Economy, XXXVI (June 1928). Knight died well before the Nobel for Economics was established in 1969, but surely would have qualified for one otherwise. His work was also based on that of the Austrian economist Friedrich von Wieser, who developed the concept of opportunity cost, and Philip H. Wicksteed.
labor theory of value. This explains why—or at least was a justification for—his idea that all property belongs to labor, that is, workers, and so capital really belongs to workers, not its capitalist owners. He argued that the capitalists should be overthrown and their factories and mines confiscated, violently if necessary, and that all property should be given to the working class, who are the owners of labor. This monstrous notion, which helped make the twentieth century the bloodiest in history and impoverished millions, shows that ideas really do have consequences.)

B. Trade creates value.
What do farmers do? Why, they perform magic. They put some tiny little seeds in the ground and at the end of the season they have a big pile of corn or cotton or whatever. Well, not exactly. Obviously, they don’t really create something from nothing. (Physics students: Recall the First Law of Thermodynamics.) What they do is to move things around. They encourage the little seeds with cultivation and fertilizer and all the rest, and hope for rain. The seeds don’t make the crops out of thin air, either, but gather substances from their environment and use the sun for energy to rearrange the stuff. Factories are often said to “make” products, but of course they also have to start with raw materials, and then apply labor and machinery and energy to produce their output. So what about service industries, like retailers? What do they produce? Consider, for example, Littrell Lumber in Decatur. They don’t produce anything, really. They just choose the logs they think will sell, take delivery of the logs, saw them into what they believe will be the most valuable cuts of lumber, and then sell them to customers. But if you want to build a house, pine logs aren’t going to help much, and lumber of the wrong size isn’t very valuable, either. But cutting the logs in the sizes builders want makes the logs more—valuable. Trade makes goods more valuable.

That’s the idea behind the Principle of Voluntary Exchange: a voluntary exchange between two people makes both people better off. And since sellers will only sell a good if the price is higher than what it’s worth to him, and a buyer will buy it only if the good is worth more than the price, trade creates value because it moves goods from owners who place a lower value on them to others who value them more highly. The more people trade, the more they prosper.

But surely this doesn’t apply to foreign trade, that is, to imports? Everybody knows that buying imported goods costs American jobs, undermines our international competitiveness, and causes tooth decay. A good part of this course is dedicated to correcting this mistaken notion. If you believe this, then you’ve probably been listening to autoworkers too much, complaining about how all them furrin cars are stealin’ their jobs. Of course, we would all be so much better off if we banned imported cars, so that they could continue to earn high wages and benefits by making poorquality cars and selling them to us at inflated prices. If you buy a shirt from a shop down the street, you both benefit. You get a shirt that you value at more than the purchase price and the shopowner can now buy something that is worth more to him than the shirt was. If you buy a shirt from a store in the next county, that’s still true. And if you buy one online from a retailer in England, that was made in Vietnam, it’s true again.

C. Middlemen.
Middlemen—oh boy, the rats, let’s get ‘em. At least that’s how a lot of popular culture seems to portray them. “Cut out the middlemen!” scream the ads, like they’re some kind of cancer. But since middlemen exist, and thrive, and other people willingly use their services, and all this has been going on for a long, long time, it must be that they provide some kind of valuable service. What is it? First, remember that value is subjective (see section A above) and that no one actually creates anything, but only rearranges natural resources in form and location (see section b above). Middlemen, like retailers provide a service that amounts to moving things around—but in a way that makes them more valuable. Let’s see how. Consider a typical used car lot. Now, running a used car dealership is probably not very high on most people’s list of honored occupations. What do these nefarious people actually do? They buy cars, either from wholesalers, other dealers, or car buyers (i.e., trade-ins) and resell them, for a higher price, of course. Now, say that Congress passes a law that makes it a capital crime to run a used car dealership. (Which, of course, would lead to illegal underground used car dealings and people skirting the law by running used car dealerships disguised as other types of businesses. But let’s ignore these activities for now.) Anyone who had a used car to sell would have to sell it himself or herself, through the classified ads or some other method. And anyone who wanted to buy a used car would have to hunt through the classifieds and drive all over the place to find the car they’re looking for. (People do this, of course, but it’s costly in terms of time.) Comparison shopping would become much more costly. Car prices would become much less consistent, as buyers and sellers alike would find it difficult to learn what cars were selling for. (There would be no Blue Book, which is compiled from data provided by used car dealers.) Buyers would be more likely to “settle” for a car that isn’t really what they want because the cost of searching for a better car would be too high. And sellers would be more frequently have to take a low price for their car because there would be fewer potential buyers. If used cars became more difficult to sell, new car dealers would find it more difficult to sell their cars, too. A great cry would go up across the land to let somebody act as a sort of clearinghouse for used cars, so that people with used cars to sell would be able to show their cars to lots of buyers at relatively low cost, and so that used car buyers could look at lots of cars at low
cost. In other words, people would shout, “Give us back our used car dealers!”

So what is a middleman?

**Middlemen provide services that reduce transactions costs and thus encourage trade.**

What are **transactions costs**? Any costs involved in making a trade. For instance, in the shoe business, the cost of leather and plastic, and labor, and of the shoeboxes, are production costs, not transactions costs. They’re incurred directly in the process of producing the shoes. But transportation costs—for shipping the raw materials to the plant and the shoes to the wholesalers and then to the retail stores—and warehousing costs, and retailing costs, such as heating and cooling and paying sales staff and handling payments, either by cash, check, or card, are all transactions costs. So is the cost of advertising, i.e., providing information to consumers. And the cost to consumers of learning what kind of shoes are available, finding where they can be bought, what prices are charged, and then going to buy them and bring them home. Since transactions costs are part of the total cost of making a trade, and since lower costs encourage trade, **middlemen encourage trade.** And since trade creates value (see section B above), **middlemen create value.** A society with no middlemen will be a poor one, since people will have to spend a lot of their (scarce) time resources to make any trade, and so will make fewer trades and be worse off.