A Moderate Compromise: Economic Policy Choice in an Era of Globalization
(Excerpt) - by Steve Suranovic (Palgrave McMillan, 2010)

Chapter 6 - The Pursuit of Profit

Economists and others, who support globalization, tend to look favorably upon profit seeking by firms. Neoclassical economic models are built on the assumptions that firms maximize profit and consumers maximize utility. Adam Smith's famous passage about the butcher, brewer and baker is often used to suggest that self-centered, even egoistic, profit seeking behavior can have positive effects for the economy. Smith said,

> "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." (Smith, 1937, para I.2.2)

Smith is arguing that the economic system provides for our wants and needs because, first and foremost, people are trying to help themselves, and they do so by producing and selling meat, beer and bread to others. These market outcomes are not achieved because of altruistic behavior. We do not appeal to other peoples' *humanity* when we seek our sustenance, but rather to their *self-interest*.

Many who view profit seeking, and egoistic behavior, almost as an evil in society, do not share Smith's notion that social benefits arise from self-interest. These groups argue, for example, that large multinational firms use their size and power to take advantage of others. Firms manipulate consumers' demands with advertising,[i] they influence government policies to favor their interests, and exploit the lower skilled workers in their companies by pushing wages down to unlivable levels. Indeed, firms may avoid environmental protections, shift jobs to low wage countries, tolerate unsafe working environments, prevent workers from forming unions and may even hire child labor in countries where worker protections are lenient or non-existent – all in the name of profit!

This chapter will argue that there are really two different types of profit seeking behavior. The first type, described by Adam Smith, will be referred to as **voluntary exchange**. From the idea of voluntary exchange comes the notion that free market activity can generate benefits for everyone – that trade is a positive-sum game. The second type of profit, emanating from the concerns of many social justice groups, will be labeled **transfer profit**. From the idea of transfer profit comes the notion that benefits to some groups arise from the detriment caused to others – that interactions are a zero-sum game. However, there are two variations of transfer profit; the first, analogous to theft, is labeled **involuntary transfers** and the second, analogous to gift giving, is labeled **voluntary transfers**.[ii]

In subsequent chapters, I'll elaborate upon these concepts of profit seeking and discuss their prevalence in today's global society. We'll also examine the fairness characteristics of each type of profit seeking and note that voluntary exchange and voluntary transfers are largely fair under most interpretations while involuntary transfers are largely unfair. Finally, understanding and using the distinction between these two variants of profit seeking provides a heuristic mechanism, a stepping stone, to guide policy choices in this complex globalizing world.

What do we Mean by Profit?

In business accounting, profit is defined as the difference between a firm's total revenue and the total cost of its inputs. It is the money left over after all the normal expenses of the company have been paid. Accounting profit represents the return to the owners of the firm since they have the right to retain any surplus for themselves. In a private firm, the owners may also be employees, in which case profit will be a surplus above what they pay themselves in wages. If the firm is a corporation with shares of stock issued, then profit will often be distributed in the form of dividends to the shareholders.

Economic profit is defined slightly differently as total revenue minus full economic cost, which, in addition to the cost of productive inputs, includes normal profit to the owners of firms for the risks they incur in running the business. In competitive markets, economic profit is driven to zero, however because under this definition an average profit rate is allowed for, accounting profit would remain positive despite achieving "zero" economic profit.

Essentially then, profit is the income received by an individual who has contributed entrepreneurial services, taken risks and provided direction and guidance for the company. Viewed as a production service that generates income, profit is similar to payments for other income generating services in the marketplace; namely, wages, rents and interest. Economists and accountants sometimes classify income acquisition into these four fundamental categories: wages, rents, interest and profit. The sum of these four items in an entire economy is one way to measure the nation's gross domestic product (GDP). It is important to highlight these distinctions because they form the basis for many of the popular conceptions and misconceptions about profit.

Wages represent the money acquired through physical work, whether it's digging ditches in the searing summer sun, or meeting with clients at a five star restaurant to close an important sales deal. Rent is either the money acquired from the usage of land or more generally by the use of any owned resource, which may include capital equipment. Rent typically describes the money earned by the owner of an apartment or office building, but can also refer to money earned as dividends by shareholders of a corporation. Interest represents money acquired when one person or company lends money to another.

Curiously, in accounting terminology, wages are classified as "earned" income, whereas income from rent, interest and profit is labeled "unearned" income. This terminology may date to the time when there was wider acceptance of the labor theory of value, which proposed that the value of all commodities was proportional to the amount of labor necessary to produce it. In other words, labor creates value because of the hard work and effort of people and therefore the money acquired from work is considered "earned." However, when capital or land owners apply their physical property in the production of something, individual physical effort is not required and therefore the income is "unearned."

This terminology is unfortunate since it imparts a negative connotation on some parts of the productive process. The modern interpretation in a capitalist system is that income payments are made to agents that contribute in some way to production. Of course, labor effort contributes to production and so wages are paid as income. However, in a capitalist economy individuals own the physical means of production. Resource ownership is sought entirely because land and capital can be applied to a production process, which, in turn, will generate income. If people could not "profit" or benefit from land and capital usage, there would be no incentive to own it (land) and create it (capital).

In the past, land and capital ownership was concentrated in the hands of a small wealthy minority. The image of a capitalist, typified in political cartoons of the late 19^{th} century, was once a heavyset, cigar-smoking, railroad tycoon, holding bags of money and trodding upon the poor defenseless masses. However, in developed countries things have changed considerably as a larger and larger proportion of the population own their own homes and have retirement plans containing ownership shares in numerous companies. This means more and more people are both workers and capitalists at the same time. In the US today, a typical capitalist is a retired woman supporting herself on the income from her 401K disbursements, plus a supplement from social security. Despite these changes in capitalist composition, the popular image of the capitalist has not changed very much. There remains a strong sense that the owners and management, especially of large multinational corporations, continue to exploit powerless workers.

One other type of income classified as "unearned" is interest income. Just like profit, money acquired as interest on loans has a long negative history. In medieval times, any kind of money lending was known as *usury* and was condemned as immoral by many religions. Still today, the Islamic prohibition on usury motivates religiously sanctioned financial services known as Islamic banking. In non-Islamic cultures usury is not restricted, but the negative connotation sometimes persists.

The reason interest income is viewed suspiciously is perhaps the same reason it is classified as unearned income. Before modern economics developed, money acquired by lending, was thought to be money out of nowhere. It required no effort and no work, and hence was viewed as pure exploitation of the borrower by the lender. The lender effectively *stole* money away from the borrower. This image is perpetuated with the stereotype of loan sharks, who lend money to desperate people and use strong-arm techniques to assure repayment. However, with the development of a modern banking system, and especially with recognition of the concept of opportunity cost, borrowing and lending was less frequently viewed as an evil.

The modern view of interest is that it is a payment for a service. That service is the privilege the borrower receives to use and spend money *now* instead of *later*. In contrast, the lender must forgo the current use of his money and what it might purchase, i.e., his own current consumption, when he lends it to another person. The opportunity cost to the lender is the forgone consumption, while the interest payment is the fee that covers that cost. Borrowing and lending, when done responsibly (which is not always the case), has been a significant contributor to the expansion of output and the raising of living standards around the world.

Thus, a more reasonable view of income from interest, rent and profit is as money "earned" because of a contribution to the productive process, in a similar manner to a wage payment for a labor service. Production requires workers to combine with capital, land and natural resources to produce the goods and services demanded by households, governments and other firms. When money is unavailable to pay for labor and capital it can be financed by borrowing from someone who prefers to save his consumption for a later time. In this case, interest payments will be paid that also contributes to production.

A More General Definition of Profit

A more general application of the term profit, then, is as a synonym for the term net benefit. To profit from an activity means to receive a net benefit. That benefit might be measured in monetary terms as with the money earned in an endeavor, or it might be measured in terms of the utility (aka happiness) acquired by an individual. Although in economics we typically assume that utility is derived from the consumption of goods and services, in more general terms utility can also arise from interpersonal relationships like friendship, or from one's perception about oneself (self image) or one's perceptions about the activities of others. For example, an environmentalist may receive a psychic benefit when learning that a whaling ship has been prevented from pursuing its intended mission. Under this very general definition, we would say the environmentalist has "profited."

Clearly this usage of the term profit is much broader than its typical use. When social justice supporters express outrage at the high profits of multinational oil companies, they are using the standard, more-narrow definition. Nevertheless, by broadening the definition, we'll be able to recognize the source of complaints by those who worry about high profits (as typically defined) and also to see that these same complaints have a much wider domain.

Returning to the four main sources of income in an economy - wages, rents, interest and profit – we may note that each of these corresponds to an individual benefit received in excess of the costs of generating that benefit. For example, the cost of work to a worker is the value of his next best opportunity, more than likely the benefits he would have experienced with leisure. Alternatively, the cost may be conceived as the disutility, i.e. the hardship, associated with the work activity.[iii] The net benefit, or "worker profit" associated with work is the wage minus that individual's opportunity cost. In a free market if the wage exceeds the value of the next best opportunity (leisure, with no income), then he or she accepts the job.

For the capital owner the opportunity cost is to leave the equipment unused, in which case he would earn nothing. Thus the rental payment itself is the net benefit or "capitalist profit" associated with the rental of his equipment. For a lender - envision a financial institution - the cost of the funds is the interest paid to depositors. A bank functions by paying depositors a lower rate of interest than is charged to borrowers. The difference between the two rates corresponds to a net benefit, or "lender profit."[iv] Finally, we return to the entrepreneur. This is the person, or group of people, who organize workers, capital and, potentially, borrowed funds in a productive activity. The entrepreneurs anticipate that the revenues earned on sales of the final product will exceed the wage, rental and interest costs, in which case they will make a net benefit, or "entreprenuerial profit."

Alternative Sources of Profit

Once we broaden the definition of profit to include any benefit received by an individual in excess of costs, we might inquire into methods, other than those described above, by which a person might profit. One obvious alternative is theft. Thieves accost people on the street, hit them over the head and run off with their wallets and purses. Bank robbers pursue larger prizes by going directly to the primary money storage facility. Con artists get people to give them their money by tricking them into thinking they will receive something of value in return – when in fact they won't. When money, or other things of value, is acquired via theft, it is not appropriate to call it income since it is not a payment for the provision of anything. However, the thief does benefit by an amount in excess of his expected cost of engaging in thievery. Therefore it is appropriate to say the thief has "*profited"* from the activity under our more general usage of the term.

Another alternative way a person may profit, besides theft, is through the receipt of a gift. The cost to the gift recipient is zero but the gift itself generates a positive benefit. Therefore, applying the general definition, it is valid to say the person has "profited" upon receiving the gift.

One final unique profit situation occurs when individuals produce benefits for themselves. For example, if a hunter shoots and kills a deer and brings the deer back for his family's consumption, then his family benefits. The cost is the opportunity cost of foregone leisure, perhaps watching a football game on a Sunday afternoon. As long as the benefits, which include the psychic benefits, or pleasure, from hunting exceed the opportunity cost, the hunter and his family profit from the activity.[v] Note, that because only one person or household is involved in this activity, there would be no recorded market activity. Thus, in some instances, profit arises outside the formal marketplace.

Finally, the suggestion of psychic benefits in the hunting example opens the door for other types of non-market profit opportunities. Thus, when a group of people protests in the streets to demand democracy, their actions are not a market activity. Nevertheless, they protest to achieve an outcome, such as freedom of speech and the right to elect their own leaders, which has value to them. Clearly, they expect the benefits of obtaining these freedoms will exceed the costs they might incur from their protests. In other words they expect to "profit" from the activity. These types of non-market benefits, like freedom and democracy are very difficult, if not impossible, to measure. However, inability to measure does not mean we must ignore them since people's behavior clearly demonstrates they are very important profit sources.

Self Profit, Voluntary Exchange Profit and Transfer Profit Defined

This classification scheme is not a new idea. Henry George (1949), in his book *Protectionism and Free Trade*, wrote, "is it not true, as has been said, that the three great orders of society are 'working-men, beggar-men, and thieves?' In a similar vein, using this broad definition of profit, we'll distinguish between, not three, but four unique methods by which individuals obtain profit. In later chapters it will be shown that any type of profitable activity one might imagine can be identified as belonging to one, or a combination of several, of these profit seeking methods. Secondly, it will be shown that in terms of fairness or justice criteria, several profit seeking methods are universally regarded as preferable to others. In the end, these profit seeking methods will be used to identify compromise principles that can guide policy choice.

Self Profit

Self-profit corresponds to any benefit an individual receives based solely on his own independent activity and without interaction with any other person. Simple examples include a primitive hunter-gatherer who kills game and picks berries for his own sustenance, or collects branches to build himself a shelter. A modern example would be a runner enjoying a morning run, or a naturalist who walks through the forest to observe bird and animal species. Washing dishes and cooking one's own dinner are examples of self-profit.

In a modern economy, because people are so interconnected, it is difficult to find many examples of pure self-profit. In most cases an individual's own benefit is dependent on the use of land, capital equipment or information. If that land, equipment or information is owned or provided by someone else, as when exercise takes place in a health club, or because running requires the purchase of appropriate shoes, then self-profit is intermingled with voluntary exchange.

Voluntary Exchange

Profit by voluntary exchange corresponds to the benefit an individual receives after engaging in a mutually voluntary exchange with another. Most exchanges consist of bilateral trade, where two people exchange one object for another. In a barter economy, we might imagine two people exchanging apples for oranges, or labor services for a meal and a place to sleep. In a money economy, people exchange objects for money; apples are sold at the market for money; labor services are offered in exchange for a wage.

When exchange is voluntary (not coerced or forced in any explicit or implicit way) we can reasonably conclude that both traders expect to benefit from the exchange, for if not, why trade? In a barter economy, an apple grower seeks out trades with an orange grower because a combination of apples and oranges in his diet is more satisfying than consuming only apples. The orange grower is likely to feel the same way, preferring diversity in his diet as well. This implies that after the trade, assuming each party received what was expected, both traders are happier than without the trade. Because each trader benefits from the exchange, it is reasonable to say that each has "*profited*" through exchange. This is the classic economic story about the *mutual* benefits that arise from exchange.

Indeed, since both traders go away happier we can claim that there is *surplus value* created because of exchange. Recognize that each person derives some happiness from consuming only apples and only oranges. After exchange, each person derives even more happiness with a combination of apples and oranges. Total happiness rises, which is why economists call this a positive sum game.

If we take this one step further, we'll realize that people are not naturally endowed with a continual supply of apples or oranges to trade with others. That means, to make exchange possible, people need to *produce* the apples or oranges or other desired goods or services that other people seek. Production, in turn, requires the combination of labor, capital, land and natural resources. When the final products are exchanged on the market, they generate income to all the workers and owners of capital, land, and resources, who contributed to the production. Thus, via market exchange, everyone who contributes to the production process will profit. This is the market story related by Adam Smith when he wrote about the butcher, brewer and baker seeking to profit via production and exchange.

Transfer Profit

Transfer profit corresponds to a benefit received by one agent as a direct consequence of a comparable loss to another. With transfer profit, there is no surplus value like there is with voluntary exchange. Nothing new is produced. Instead, one person's gain is another's loss.

There are two variations of transfer profit. Involuntary transfers occur when the transfers are made unknowingly or without consent, as with theft. In contrast, voluntary transfers arise when the transfers are made willingly, as with gifts, charity and philanthropy. These differ because, with involuntary transfers, the transfer is *caused* by the profit recipient, whereas with voluntary transfers the transfer is *caused* by the giver; the person who does not receive the profit.

When critics of globalization complain about the evils of profit seeking, when they argue that large multinational corporations are controlling the decisions of government institutions, when they openly worry about harmful labor market practices in developing countries, they are reacting to different manifestations of involuntary transfers. Similarly concerns about involuntary transfers arise among free market advocates as well, albeit directed at different situations. For example, when people complain about the vast power of the government to transfer money away from people and control the decisions they can make, they too are reacting to a manifestation of involuntary transfer profit. Also, when we study the ravages of war throughout history and react with sorrow at the death and destruction, we are reacting to perhaps the most notable example of involuntary transfers.

In his famous treatise, "The Law," first published in 1850, Frederic Bastiat emphasized the problems associated with the widespread tendency for people to engage in involuntary transfers; what he referred to as "plunder." Bastiat wrote, "… *man* may *also* live and enjoy, by seizing and appropriating the productions of the faculties of his fellow men. This is the origin of plunder. Now, labor being in itself a pain, and man being naturally inclined to avoid pain, it follows, and history proves it, that wherever plunder is less burdensome than labor, it prevails; and neither religion nor morality can, in this case, prevent it from prevailing."[vi]

Egoism and Altruism

A controversial issue that affects the debate about profit seeking behavior concerns the acceptance, or the perceived morality, of egoism and altruism. Economists, among others, have generally accepted egoistic behavior as a natural characteristic of people. Furthermore, following the teachings of Adam Smith, they argue that egoism can actually lead to socially beneficial outcomes in the marketplace. To many, egoism, greed even, is a good characteristic.[vii]

Nonetheless, most people seem to regard egoism as a character flaw at best. They see self-interested behavior as the source of problems, even a source of evil, in our society. To most people, greed is something we should all strive to extricate from our personal behavior. The suggested alternative is to act altruistically: to give rather than receive; to do good things for others without demanding or expecting anything in return.

Figure 6.1 illustrates a series of transfers between two people to highlight different viewpoints concerning egoism and altruism. The rows signify the three main types of interactive profit realization: involuntary transfers, voluntary transfers and voluntary exchange. The color of each box indicates whether the person gains (green) or loses (red). Also depicted is the person responsible for initiating each transfer, that is, the chooser.

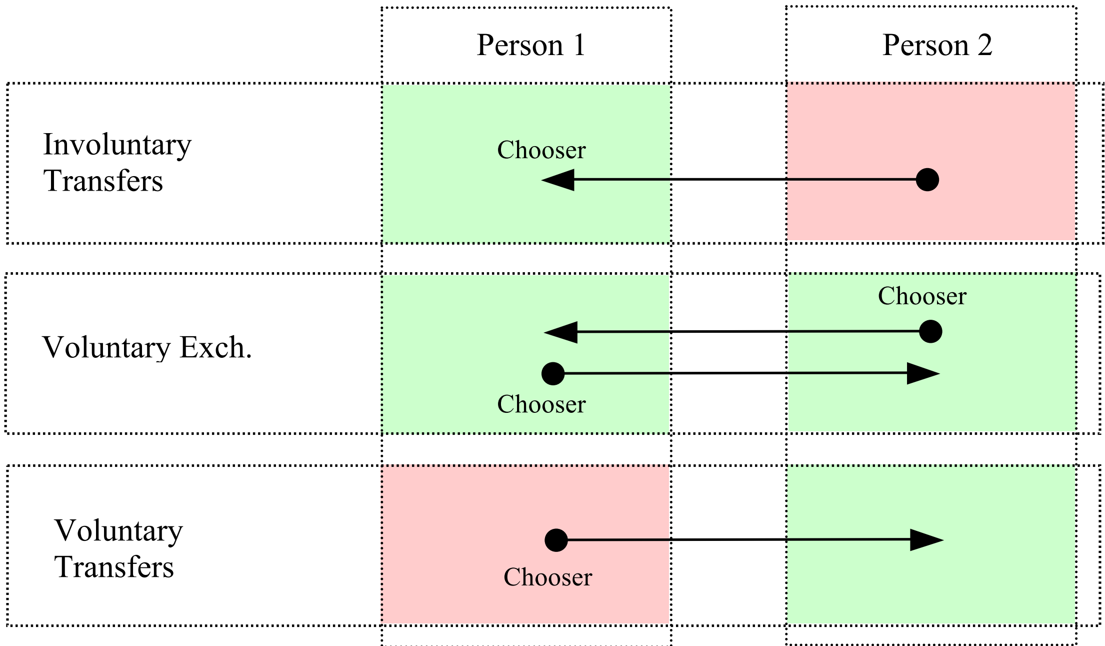
In the case of involuntary transfers, Person 1 chooses to initiate a transfer that makes himself better off while causing harm to Person 2. If Person 1 is egoistic, then he may believe it is acceptable to take any type of action that causes self-benefit, even if it causes direct harm to someone else. However, to most people, this kind of behavior is condemned because of the involuntary losses to the victim. In addition, egoism, the sentiment that leads to this negative outcome, is often faulted as the culprit. When people criticize egoism they very likely have this type of activity in mind.

Many believe that the moral alternative to egoism is to act in ways that are altruistic; to give of oneself selflessly. Note that this is precisely the situation described with voluntary transfers. In that case, Person 1 chooses to give to Person 2. Person 2 receives a benefit while Person 1 suffers a comparable loss. But even though one person gains at the other's expense, just as with involuntary transfer profit, it is clearly superior since the person who loses, *chooses* to make the transfer. It is difficult to find fault with this.

The moral controversy seems to be whether an effective society requires the promotion of altruism to overcome the negative consequences of unbridled egoism. Fortunately, there is a moderate alternative that stands between the two extremes. That compromise is voluntary exchange. In this case, Person 1 chooses to give something to Person 2 while simultaneously receiving something back in return. From the principles of voluntary exchange each person gives up something of less personal value than what they receive, leading to gains to both people. (hence both boxes are colored green).

Whether exchange-transfer-actions are egoistic or altruistic depends on one's perspective. In Adam Smith's butcher-baker story, he emphasizes the egoistic aspects of exchange; that each person exchanges because they expect to benefit. However, one could just as easily focus on the giving side of the exchange. Each person produces something that will be given to another, thus generating benefits. From this perspective each person's actions are altruistic.

Figure 6.1 Alternative Transfer Scenarios



Since the effect of exchange is a benefit to both people, it stimulates the best aspects of egoism and altruism. Notice that voluntary exchange consists of two simultaneous actions precisely like the altruistic voluntary transfer case – each person chooses to give something to another. In this way voluntary exchange can be thought of as an *altruism pairing*. Also, since each person benefits from the giving of the other, people may be willing to partake in exchange *because* they are egoistic. However, egoism in this exchange case is nothing at all like the application of egoism in the involuntary transfer case because neither person chooses to take something from another; instead both sides of the transaction are voluntary.

The point of this diversion into egoism and altruism is to make the following claim: most of the presumed evils in the world arise because of reactions to involuntary transfers, not because of the egoism or greed inherent in the individual chooser. Those who argue that we need to squash human egoism and promote altruism are partially correct but partially misguided. Egoism and greed are definitely associated with the negative outcomes arising out of involuntary transfers. Altruism is also clearly associated with the positive outcomes arising with voluntary transfers. However, to disparage egoism in favor of altruism also condemns the positive interactions that arise out of voluntary exchange. And, as will be suggested in the next section, it is the growth of voluntary exchanges that have stimulated most of the advances of modern human society.

At the same time, free market advocates who sometimes seem to suggest, like Gordon Gekko, that greed is always good are also exaggerating their point.[viii] Egoism and greed that stimulates voluntary exchange is clearly beneficial, but that same greed is detrimental when it motivates involuntary transfers. Thus, greed is not always good. At the same time though, a lack of greed is clearly bad, since it would incapacitate one of mankind's most important advances; namely voluntary exchange.

Profit Seeking and the Evolution of the Modern Economy

When scientists discuss the behavior of man in modern society they often recognize that man evolved over hundreds of thousands of years and that many of the traits embodied in man's behavior are those adapted to a much more primitive way of life. Modern recorded society has existed for little more than five thousand years. In evolutionary terms, that is like the blink of an eye. With this in mind we can inquire into the fundamental evolutionary tendencies of man and animals with respect to the methods used to seek profit, i.e., to benefit themselves, and consider how and why those methods have evolved in modern times.

Consider first the method used by a carnivorous animal, such as a lion, to acquire the food it needs to survive. After taking up a position hidden in the high grass, downwind from where a herd of zebra is grazing, the lion will wait until the herd approaches sufficiently near. Then with a sudden burst of speed and energy the lion will burst into the open and pursue the animal closest and easiest to attack. The victim will often be a younger or weaker member of the herd. After pouncing upon, and bringing down the hapless prey, the lion will brutally bite into the neck of the animal to quickly incapacitate and kill it. Afterwards, the lion and its pride will leisurely devour the zebra.

As the feast progresses, other animals in the vicinity will smell or see the new food source. Rarely will other animals attempt to steal the prey away from the lions since they understand the lions will protect their food with deadly force if necessary. At this stage we might say that the lions effectively *own* the carcass since they have the power to protect it for their own consumption. Nevertheless, were the lions to leave the carcass unattended, other animals would quickly descend upon it to claim it as their own, in the approximate order of more to less powerful. Thus, this implied ownership of a food source lasts only as long as the animal remains prepared to defend it.

Once the lions have had their fill and move on, the remains of the carcass become the food source of hyenas, birds, small mammals and eventually the bacteria that will return the animal's body to the earth.

Every living thing on the earth requires food, air and water to satisfy its most basic need; to remain alive. In nature, every living thing satisfies this need by *taking it* from its environment. The plants *take* the nutrients from the soil where its seed has sprouted and uses the rays of the sun that fall upon it. Animals *take* the fruits, nuts and seeds from other living organisms. Carnivores use their speed, power, intelligent instincts and other evolved traits to *take* the lives of other living creatures. Every creature on earth survives by taking what it desires, what it needs to survive. No one asks permission. To the extent that ownership, or a claim, to a food source exists, it is fleeting, lasting only as long as the animal is prepared to defend it.

In terms of the methods of seeking profit described above, the natural state is involuntary transfers between egoistic species. The plants whose leaves are eaten, or whose fruits and seeds are taken by other animals, don't choose to provide these to others. The animals that become a food source for other animals never choose to do so. These actions are always involuntary; the animals that take food to survive never ask permission from the provider. Involuntary transfers are the basic state of nature.[ix]

Next, consider pre-modern humans. Early humans survived like all other animals, either collecting edible fruits, seeds and plants, or killing animals in the wild. However, as human capacities developed, they also developed the ability to plan for the future. With this came the creation of tools for specific purposes – tools that could be used over and over again for hunting or cooking – capital equipment in modern parlance. With the ability to plan for the future, man also learned to store food that had been collected or killed.[x]

The development of agriculture via the cultivation of grains and the domestication of animals opened up new opportunities for humans. One of the most important features of these new production methods was the reduction of the costs associated with searching for food. In addition, continual experimentation led to the development of more effective tools and cultivation techniques, which increased productive output for a given amount of time and effort. Because costs were reduced and output simultaneously raised, communities began to produce surpluses.

Surpluses in households or communities could be used in two ways. First, they could be stored. Grains could be stored in pots and protected from the elements. Fish and meat could be salted to prevent spoilage. Domestic animals could be bred and kept alive until they were needed for food. Alternatively, surpluses could be traded for other desired items; for example, surplus grain in exchange for fish or tools.

Trade and exchange also developed because of the advances made possible by the division of labor, which allowed individuals to specialize in particular productive activities. Some could become tillers and harvesters, others the caretakers of animals, and others the makers of tools. By specializing in particular occupations, each person would become more knowledgeable about one production activity and accordingly could increase productivity. Because of specialization coupled with the desire of most individuals to consume a variety of goods, surpluses were inevitable. The division of labor enabled each person to produce much more of their specialty item than what they themselves desired of that good. Such a surplus is only valuable if it can be traded for other items whose producers themselves are also faced with a surplus relative to their own desires.

Mutually voluntary exchange facilitates the division of labor and thus is necessary for the success of the agricultural and industrial revolutions. Without trade, the advance of human civilization beyond hunter-gatherer societies would appear to be untenable.

Nonetheless, although the possibility of trading opportunities can motivate the desire to produce surpluses, which in turn can stimulate the division of labor, the presence of surpluses also has a secondary effect.

As communities become richer, not only will they stockpile grain surpluses and expand the number of domesticated animals, but they will also create a larger stock of tools, implements, housing structures, housewares and trinkets. This stock of wealth, all of which would be valuable to other humans, accordingly becomes a target for bandits and marauders. Once some communities have some wealth, other groups have choices between two distinct ways to profit; either produce for themselves by exploiting nature directly, or, steal from others.

Taking from nature, although it represents involuntary transfers between species, would be classified as self-profit above, since the hunter-gatherer need not interact with any other human to provide for his own sustenance. However, if the human acquires what he desires by stealing stored, or recently gathered, foodstuffs from other humans, then it becomes an instance of involuntary transfers. Furthermore, one may presume, since throughout evolutionary history humans were used to taking what they needed directly from nature, that taking from other humans instead, either by force or subterfuge, would amount to much the same process. Indeed, one might well argue that it is more natural for man to steal from others, be it nature or other men, than it is to produce and exchange.[xi]

Of course, either process involves some cost; taking from other humans can be as difficult and dangerous as taking from nature. However, depending on the circumstances, one or the other will be easier, or less costly, to undertake. One can imagine that early humans would choose whether to take from nature instead of from other humans if either the size of the gain was larger or the cost, or effort, of doing so was lower. That is, humans would choose the method that generates the greatest net benefits; that is, that which is most profitable.

A community that has not developed the knowledge or ability to produce a surplus may find it less costly to create weapons and carry out raids of communities known to possess surplus commodities. Indeed, as the agricultural revolution extends to more communities and as more surpluses develop, we might expect it to become easier for non-surplus communities to take from others rather than taking directly from nature.[xii]

The productive trading communities, of course, will try to defend their possessions from these bandits. Thus, some of their surplus production will need to be diverted to produce weapons for defense and perhaps, in larger communities, defenses such as walls and a security force; all this to protect their "property" or possessions.

This simple story suggests that the evolution of modern human society can be seen as a transition from a state in which humans satisfied their needs entirely via involuntary transfers to a state in which humans satisfy their needs via production and voluntary exchanges. An important lesson of modern economics is that the growth of living standards depends critically on specialization and the division of labor, which in turn depends on the viability of mutually voluntary exchanges. To make the growth of human welfare possible, societies have developed a variety of mechanisms that serve to promote voluntary exchange (e.g. establishment of rules regarding private property) and to ward off the potential for involuntary transfers (e.g. moral dictates like "thou shalt not steal"). However, although the transition to a society with a preponderance of mutually voluntary exchanges and the elimination of involuntary transfers is well on its way, it is neither complete nor inevitable.

Property

The operation of voluntary exchange, involuntary transfers and voluntary transfers requires an implicit, and so far unstated, assumption; namely that the items exchanged or transferred *belong* to someone involved in the transaction. Ownership claims arise in a variety of ways; from a simple assertion that what I possess is *mine*, to a formal legal title issued by a government carefully identifying the property and the person or entity that owns it. The legitimacy of property ownership claims is a complicated question that has motivated substantial discussion and debate over the centuries.

John Locke argued that individuals own themselves and as a consequence can also claim any products that come from the exertion of one's own effort. Thus, when an individual combines his labor effort with wood from the forest and produces a table, the table can rightly be regarded as his property. Even simple stories like this, though, are fraught with complications. Thus, one could ask whether the wood taken from the forest was rightfully his before he applied his labor.[xiii] Nevertheless, despite the complications, I would expect that if another person steals away the first person's table and claims it as his own, the original producer would surely object. Thus, legitimate or not, the producer *believes* the table is his. This suggests that the concept of property is prior to any state regulation or philosophical definition. In nature, people will often collect or take whatever they are capable of, and will effectively claim the items as their own. Theft is only considered theft if the original holder of the stolen items believes they are legitimately his own; for if he does not, there can be no complaint.

The fear of losing ones claimed property also inspires efforts to defend that property from being taken by others. One method of defense is the creation of a security force, whose members develop the weapons and expertise needed to protect the surplus from theft. In exchange for these services the defenders can receive a share of the surpluses generated. In this way a benevolent government can develop whose primary mission is to protect the property of citizens in a community.

However, just as weapons can be used to defend, so they can also be used to attack and control. Thus, as mentioned before, as surpluses became prominent in agrarian societies, it also became easier to apply effort to the production of weapons and to establish armies that could effectively steal the surpluses away from the producers. It is in this way that malevolent governments are formed.

In modern societies complex legal practices and institutions have developed to protect claims to private property, especially with regards to land, but also with regards to financial assets, inventions, trademarks, artistic creations and even frequency bands. Formal legal titles to property are regularly provided, monitored and enforced by government agencies. Nevertheless, not every possible valuable asset is currently titled around the world. Informal or implicit property rights remain an important element in some sectors and in some countries.

Hernando De Soto (2000) offers an excellent survey of informal, or extralegal, property arrangements that persist in many developing countries. Perhaps the most memorable is his suggestion to use the barking of dogs to identify who lays claim to property in rural areas. He writes:

> As I strolled through rice fields, I had no idea where the property boundaries were. But the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs may have been ignorant of formal law, but they were positive about which assets their masters controlled. (p. 162)

Following the barking dogs offers a useful metaphor to think about ways to identify other informal assignments of property rights in many different contexts. DeSoto's book is an excellent guide to both formal and informal property right arrangements both today and throughout history.

In the rest of this book, we won't take up the complicated issue of property, except to say that it is an important requirement both to facilitate voluntary exchanges and to explain the negative reactions to involuntary transfers. Without property, exchanges will not take place. Without property it is impossible to have something stolen away.

Next Steps

The chapters that follow will elaborate upon the concepts of voluntary exchange, involuntary transfers and voluntary transfers. Chapter 7 will show that involuntary transfers are common in modern society in forms that go well beyond simple theft. With the evolution of a complex society comprised of an equally complex set of operating rules, people have developed clever techniques to transfer benefits to themselves while at the same time justifying these actions as fulfilling a social purpose. Whenever these actions are recognized as involuntary transfers, as they often are by at least some observers, they are roundly chastised. Indeed, I will argue that many of the complaints people have about the way society functions, on all sides of the political spectrum, are inherently complaints about perceived instances of involuntary transfers. Sometimes these perceptions are accurate, but at other times it seems likely that people form false impressions. One objective of research, then, is to determine in which circumstances the perceptions of involuntary transfers are valid.

Chapter 8 will illustrate how an economy is likely to function if it operates strictly on the principle of free, mutually voluntary, exchanges; a principle consistent with a free market competitive economy. The chapter will demonstrate that both positive and negative outcomes are likely to arise in a dynamic free market. The realization of losses, which is a natural outcome when markets function appropriately, is nonetheless sometimes characterized in terms of involuntary transfers. I'll contend that this is what leads, in part, to the negative reactions some have about profit seeking and the operation of free markets.

Chapter 9 discusses manifestations of voluntary transfers, or gifts in modern society. These transfers become possible only after a society establishes a surplus in production. It seems natural, in modern times at least, that a compassionate society would share a portion of its surplus with those who are unable to satisfy their most basic needs or who may not be able to achieve a certain minimum standard of living. Sharing is notably encouraged by most moral and religious codes. Some contend that a compassionate society ought to consist of a preponderance of voluntary transfers. Unfortunately though, the positive productive incentives, which can raise people's living standards in a free market economy, are likely to be discouraged by an overexpansion of voluntary transfer activity.

The more important implication of this discussion is to suggest that a focus on understanding and distinguishing the three types of profit seeking provides an analytical framework for the choice of public policy. As will be explained, the framework lies squarely in the middle of popular opinions across the political spectrum. As such it represents a true moderate compromise proposal.

The application of this framework is different from current methods. The common analytical framework applied today is to ask whether any proposed policy is "good" in some overall sense. Does the policy raise national welfare? Is the policy economically efficient? Do the positive effects, economic and otherwise, outweigh the negative effects? Is the policy fair? As discussed in earlier chapters, these questions cannot be answered with a high degree of confidence using the available metrics.

The alternative is to consider public policies in light of the degree to which they might stimulate *voluntary exchange* and *voluntary transfers* and discourage *involuntary transfers*. In the end, the overall welfare objective remains the same, except that now, the same objective is sought indirectly by thinking how policies and institutions affect behavior.

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[i] See Klein, Naomi (2000), "No Logo," Knopf, Canada.

[ii] As there are two types of transfers, voluntary and involuntary, we might image there would be both an voluntary and involuntary exchange. Indeed, there are. Symbiotic relationships, which are those in which both parties benefit are often involuntary: in which case they fit the bill for an involuntary exchange. Examples in nature include the birds who pick parasites off the backs of large animals providing themselves food and relief to the large animal. Another example is the mutual benefits obtained between

animals and the bacteria in their stomachs. However, since examples among humans seem rare, I have not added this as another category.

[iii] The disutility of work is really the same thing as the benefit of leisure. The worker dislikes work, presumably, because he compares it to the value of not working.

[iv] Note if the lender used his own money, the opportunity cost is the interest he could have earned had he deposited the money into a bank. So even in this case the lender profit is the difference between lending interest rates and deposit rates.

[v] Although, technically, the non-hunting members of the household are the recipients of a gift.

[vi] Bastiat, Frederic, (1998), "The Law," translated from the French by Dean Russell, Foundation for Economic Education, Irvington-on-Hudson, NY. p. 6.

[vii] "Greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, (for) knowledge has marked the upward surge of mankind." These words were spoken by the character Gordon Gekko (played by Michael Douglas) in the movie Wall Street. The movie was released in 1987, at the tail end of the heady times of the Reagan-Thatcher revolution that ushered in conservative governments in the US and Britain. It was a time when the belief in the potential of free markets, unfettered by government intervention, was perhaps at an all time high.

[viii] See footnote 7 for the reference to Gordon Gekko.

[ix] This natural state is precisely the motivations of man described by Hobbes in Leviathan. Quoting Hobbes from Kuenne (1993; p35), "Man, therefore, obsessed by pleasure and power, and essentially equal in ability with his fellows in the Hobbsian

natural state, is unsocial, brutal in his treatment of others, utterly selfish in his goals, and frightened by the consequences of the like motivations of others for his life and freedom. Life in such conditions is a 'war of all against all, … solitary, poor, nasty, brutish, and short.'"

[x] Gilbert (2007) argues that the fundamental difference between humans and other animals is the human ability to think about the future. This is possible because of its relatively large cerebral cortex. He suggests that other animals, which seem to plan for the future, like birds building nests or squirrels hiding nuts, are merely acting out of instinct. It seems plausible that the contemplation of the future enabled many important advances in human society.

[xi] Bastiat (1998) wrote, " … there is also another tendency that is common among people. When they can, they wish to live and prosper at the expense of others. This is no rash accusation. Nor does it come from a gloomy and uncharitable spirit. The annals of history bear witness to the truth of it: the incessant wars, mass migrations, religious persecutions, universal slavery, dishonesty in commerce, and monopolies. This fatal desire has its origin in the very nature of man—in that primitive, universal, and insuppressible instinct that impels him to satisfy his desires with the least possible pain. (p. 4-5).

[xii] This simple idea can also provide an explanation to an age-old question: why is there war? The answer may be as simple as noting that some communities (nations) may determine, perhaps inspired by their envy or greed, that it would be more profitable to take from other countries than to satisfy one's desires for oneself. However, once offensive actions are taken and plunder is successful, the aggrieved parties are sure to feel a desire for retribution, for revenge. Thus, successful aggressions can inspire future

retaliations, which in turn can lead to conflicts that can stretch over centuries, as history can readily attest to.

[xiii] Nozick (1975) discusses a principle of justice in rectification, governing the proper means of correcting for past injustices in acquisition and transfer.   In other words, what happens if someone trades something he doesn't own?