Chapter 1

Gains from Trade

1.1 Motives and objectives

Broadly

Let us step back from a specific managerial decision and consider the markets in which we make our transactions—whether we are managers (who hire workers, buy other inputs, and sell products) or consumers (who sell labor for a wage, trade houses, and buy food and automobiles).

Most of these markets have many (or at least several) sellers and buyers, none of whom controls the markets. The sellers and buyers have fairly narrow self-interested goals and are not looking out for the collective interests of all the participants. There are many different ways in which trade takes place. Markets are indeed complicated, disorderly beasts.

Yet we can build a simple model that captures the essential features of a variety of markets. This model helps us understand what transactions end up taking place and at what price. We can measure how buyers and sellers benefit from trade and we can answer the question of whether such markets are an efficient way to conduct trade. We can also determine the impact of a tax or of a trade restriction on buyers and sellers.

This is the subject of Chapters 1 and 2. We study a market for an indivisible good (e.g., paintings, refrigerators, houses, cars, books) in which each buyer purchases at most one unit (unit demand) and each seller supplies at most one unit (unit supply). The good is homogeneous, meaning that all units of the good are identical.

This does not describe many real markets. For example, though it is a good approximation to say that the each household wants to purchase at most one refrigerator or one furnace, the firms that sell such goods typically produce more than just one unit. In the used-housing market, both buyers and sellers are buying or selling at most one unit, but the goods in such a market are far from identical to each other.

However, as usual a model does not have to be realistic in order to help us understand the real world. The model of a simple market studied in Chapters 1 and 2 provides an introduction to basic concepts that appear throughout this book and that are relevant to realistic and complicated markets: (a) valuation and cost, (b) surplus, (c) market equilibrium, and (d) efficiency.