The Economic Naturalist
In Search of Explanations for Everyday Enigmas
by
Robert H. Frank
You can vote for anyone you want. I don’t care. You can vote for:

- John Edwards
- Barack Hussein Obama
- Hillary Clinton
- *Al Gore*
The Tragedy of the Common

• WHY ARE WHALES IN DANGER OF EXTINCTION, BUT NOT CHICKENS?
  – No one owns whales, while most chickens are privately owned
The “No Cash on the Table” Principle

• Two economists are on their way to lunch when they spot what appears to be a $100 bill lying on the sidewalk
• When the younger economist stoops to pick it up, his older colleague restrains him, saying “that can’t be a $100 dollar bill”
• “Why not?” asks the younger colleague
• “If it were,” comes the reply, “someone would have picked it up by now”
The “No Cash on the Table” Principle

• Freely available money seldom sits unclaimed for long

• The only way to make real money is through some combination of talent, thrift, hard work and luck
  – Yet many believe they can get rich quick by looking for money on the table that other smart and knowledgeable investors don’t see
The “No Cash on the Table” Principle

• When your stock broker tells you he has found a stock that is undervalued he is saying he is smarter than all the other people who have evaluated the stock
  – Buy Index funds
  – In 2000, there were 28,000 recommendations on US companies by brokerage house analysts, of which more than 99% were either strong buy, buy or hold
    • Yet a substantial share of American companies saw their stock prices decline in 2000, many of them by more than half
The “No Cash on the Table” Principle

- Companies who find “cash on the table” will soon discover a host of competitors who are after the same cash
  - The result is a decrease in price of the product or service and the evaporation of the cash that was on the table
How can you offer a discount price to price sensitive customers who would not otherwise buy your product or service and not risk having your price insensitive customer taking advantage of the discount?

– Create a hurdle that the customer must jump in order to take advantage of the discount.
The Economics of Discount Pricing

• A discount hurdle is effective if potential buyers are highly price sensitive (and probably would not purchase the product without the discount) and find the hurdle easy to jump
  – Buyers who are not price sensitive may determine jumping the hurdle is not worth the effort
The Economics of Discount Pricing

• The law of one price applies most forcefully in perfectly competitive markets such as gold and salt.
  – The threat of arbitrage deters any discount pricing.

• Many products are not sold in perfectly competitive markets.
  – For example, films in a given genre may seem interchangeable, but local screenings are not.
The Economics of Discount Pricing

• Screenings may differ in location and time, and matinees are usually offered at lower prices
• Owners can offer discounts to specific groups of price sensitive people such as seniors and students because there is no chance of arbitrage
  – When the seller is offering an experience, not a tangible product, opportunities for arbitrage are inherently limited
The Economics of Discount Pricing

• The most common example is the temporary sale
  – Those who are willing to expend the effort can obtain a discount by becoming aware of the sale and when it takes place
  – This is often done by reading in detail the Sunday ads in the newspaper
  – The buyer must also be willing and able to buy where and when the discount is offered
    • Bill and Melinda Gates will pay a higher price for sheets because they are not willing to wait for the January White Sale
Marginal Costs

• The cost of producing one more unit
• Marginal costs go down as volume goes up
• To survive in the long run, producers must sell their output at prices that, on average, are at least as great as their average cost of production
Marginal Costs

– It is often advantageous for producers to sell “some” of their output at prices less than the average cost
  • This is true when the additional unit is sold above marginal cost and does not require cutting prices on units sold to other buyers
The Saturday Night Stay-Over

• Business travelers are far less price sensitive than leisure travelers
• Business travelers want to spend time at home with their families
• Leisure travelers prefer to travel on weekends
The Saturday Night Stay-Over

• Business travelers do not want to jump the Saturday hurdle, while it is seldom a problem for leisure travelers
• The airlines are able to charge leisure travelers a price above their marginal costs and business travelers a price about the average fare
• Why do brides spend so much money – often many thousands of dollars on wedding dresses they will never wear again, while grooms often rent cheap tuxedos, even though they will have many future occasions that call for one?
Brides want to make a fashion statement on their wedding day

- A rental company would have to carry a huge stock of distinctive gowns — perhaps forty or fifty in each size
- Each garment would thus be rented only infrequently
- The rental company would have to charge a rental fee greater than the purchase price of each garment
– Because grooms are willing to settle for a standard size, a rental company can serve the market with an inventory of only two or three tuxedos in each size.
• Why do women’s clothes always button from the left, while men’s clothes always button from the right?
  – 90% of the world’s females are right-handed. For them, it is much easier to button from the right.
– When buttons were first introduced, the wealthy female buyers were dressed by servants
  • It was easier for the right-handed servants to button from the left
  • Men typically dressed themselves
– Producing women’s clothing that buttons from the right would be a huge benefit
  • Has the time arrived?
• Why does Victoria’s Secret offer multimillion-dollar jewel-studded bras that no one ever buys?
  – For the past decade, Victoria’s Secret has highlighted one particularly expensive gift in each year’s Christmas catalog
• The 2006 entry was listed at $6.5 million
• Although the bejeweled bras never sell, they attract media attention
• Their mere presence in the catalog shifts the frame of reference that defines appropriate spending for a gift
Why are Hotel Minibar Prices So Exorbitant?

• Evian mineral water from a hotel minibar often costs $4 when the buyer could go to the local drugstore and buy it for 99 cents

• The margins in hotel rooms are very thin and to attract buyers the hotel must charge a low room rate
Why are Hotel Minibar Prices So Exorbitant?

– To make up for the low margin room rate the hotel must make it up on other services

– The minibar attracts customers who are not price sensitive and are unwilling to go to the local drugstore to buy water

– Many hotel guests are employees of companies that pay the bill and thus are not price sensitive
Why Do Many Companies Offer Internet Discount Rates?

• People who are willing to take the time to go online to purchase a product or service have been shown to be price sensitive

• Amazon.com vs. Borders Books
Why Is It More Expensive to Transfer Funds Between Banks Electronically Than Send a Check Through the Mail?

- Banks typically charge a $15 EFT fee and no charge for a check that arrives through the mail – even though the deposit of the check costs the bank more money.
- An EFT can occur at the speed of light while a check may take days to be deposited and cleared.
Why Is It More Expensive to Transfer Funds Between Banks Electronically Than Send a Check Through the Mail?

– Customers who use EFT reveal that speed is important to them, and they are willing to pay for it

– Price sensitive customers do not value speed and are willing to go through the hassle of mailing a check
Why Might an Appliance Retailer Hammer Dents Into the Sides of Its Stoves and Refrigerators?

- The “scratch and dent” sale requires three hurdles. The customer must:
  - Take the trouble to find out when the sale occurs
  - Clear her calendar so she can get to the store on the day of the sale
  - Live with the knowledge she has a blemished appliance
Why Do Airlines Charge Much More for Tickets Purchased at the Last Minute?

- Businesses are more likely to have to change their schedules
- Passengers who change at the last minute have fewer options
If a “Cup” is supposed to be eight ounces, why is the smallest cup of coffee listed on the Starbucks menu a “Tall”, which contains twelve ounces?

• Starbucks does sell an eight ounce cup of coffee (a Short) for 30 cents less than the Tall
  – The hurdle is you must know enough to ask and you must ask
Why Are Round-Trip Airfares from Kansas City to Orlando Lower than Round-Trip Airfares from Orlando to Kansas City?

- The Kansas City to Orlando round-trip sells on Expedia.com for $240
- The Orlando to Kansas City sells for $312

A passenger flying from Kansas City to Orlando is more likely to be a leisure traveler while one from Orlando to Kansas City is more likely to be a business traveler.
Opportunity Costs

The opportunity cost of engaging in an activity is the value of everything you must give up to pursue it.
Opportunity Cost Illustration

• You have won a free ticket to see an Eric Clapton concert tonight – you can’t resell it
• Bob Dylan is performing on the same night
  – A Dylan ticket costs $40
  – On any given day you would be willing to pay $50 to see him perform, but no more than $50
Opportunity Cost Illustration

• There is no other cost of seeing either performer
• What is your opportunity cost of attending the Clapton concert?
  – $0
  – $10
  – $40
  – $50
Opportunity Cost Illustration

• The correct answer is $10
  – By not attending the Dylan concert, you miss out on a performance that would be worth $50 to you, but the Dylan ticket would cost $40
  – $50 - $40 = $10
  – If seeing Clapton is worth $10 to you, you should attend his concert, otherwise you should see Dylan
What I Have Learned Since Selling Chief Executive Boards

• The value of work is highly overrated

• In terms of opportunity costs, many people give up highly valuable things in life in order to work. A person on a business trip gives up the opportunity to:
  – Spend time with spouse
  – Spend time with children and other loved ones
  – Spend time exercising
  – Spent time thinking
What I Have Learned Since Selling Chief Executive Boards

• Many people willingly to give up the things they say they value most in life
  – We always have time for the things we put first

• Most Americans are taught the only way to be happy in life is to have very strong desires (goals) that are attained through work
  – They are even encouraged to have stretch goals and are promised a place in heaven through hard work
  – The Buddha believed that all life is suffering and the source of all suffering is desire
What I Have Learned Since Selling Chief Executive Boards

• Not all people hold the same values as Americans

• Not all people want to hold the same values as Americans
  – “Everyone knows Communism is the best economic system, it is just not practical”
  – “Russians don’t want too much democracy”
  – “In America people without jobs are left to starve to death”
What I Have Learned Since Selling Chief Executive Boards

– “Free health care is very important”
– “Muslims already have a constitution, it’s called the Koran”
– “Alcohol, marijuana and prostitution are good”
“il dolce far niente”
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