

2.5 Wealth Creation – Drawing the Boundaries

The message in Chapter 2.4 was clear: count the net benefits from trading. Three important questions were not answered and we'll turn to these now.

Risk Sharing Important but Separate

Our first question was whether risk sharing should be counted as a benefit. A transaction can certainly produce benefits even if it does not impact the broader public. The insurance policy is an example. Either you don't make an accident, and the insurance company collects the premium, or you make an accident and you get money from the insurance company. You won, because you bought, for a small price, peace of mind. The insurance company also won by successfully integrating many transactions and having a viable business. Risks are transferred from individuals to a bigger counterparty that can blend them in. It is important to recognize this benefit - we just chose to wait until we introduce the third Lego piece.

Broader Public Benefits Only

Replace the insurance company with the casino, the policy holder with the gambler, and peace of mind with pleasure. The benefit argument still sounds true. The casino is not that different from the insurance company at all, they have a viable business. The benefit to the individual, however, is different – it is pleasure and not risk sharing. Nevertheless, it is a benefit. Should we take it into account? We must be careful here. In any voluntary exchange of two people, monetary or not, both parties would derive some benefit, because otherwise, by definition, the exchange would not have happened. True – it's a benefit, but we must remember that our analysis is eventually about evaluating financial products so we must draw the line somewhere. To that end, we draw the line where there are benefits to the society, not just individuals.

Benefits From Contracts Only

Factors such as job creation and tax revenues are sometimes put forth as public benefits to justify certain institutions. Gambling is the classic example. This is driven by the fact that participants derive entertainment utility and are therefore willing to pay for the associated services. This creates a business opportunity, which, in turn creates various economic benefits for the public. The net benefits from such businesses are also outside our framework. *What is covered in our calculation is the benefits that are created by the contracts alone, and not by the companies that build a business based on trading.*

Let's recap what our second Lego piece doesn't count and why.

Risk sharing	Very important benefit that should be recognized and counted. We just do it later.
Entertainment utility	Slippery slope. Our focus is on broader public benefits.
Business benefits (taxes, job creation etc.)	Slippery slope. Our focus is on benefits from contracts.