GreatHearts®

Economics 10: Rise of Capitalism & Economic Systems

April 13 - April 17

Time Allotment: 20 minutes per day

Student Name: ___________________________________

Teacher Name: ___________________________________

Economics 10: Capitalism/Economic Systems
April 13 – April 17

GreatHearts®

Packet Overview

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Friday, April 17	1. List the basic economic questions each society must face 2. Identify the ways a society can organize its economy to answer these questions 3. Identify how the United States organizes its economy to answer these questions ***Quiz***	22

Additional Notes: Welcome Back! Hope you had a restful and joyful holiday weekend! This week we finish our look at the rise of Capitalism and turn towards how societies manage their economies.

Again, I now have "Office Hours" via Zoom ***on Tuesday and Thursday from 1-1:50 you can connect with me via Zoom*** to ask questions, discuss concepts etc... However, you can email any time! Please continue to ask questions! E-mail: Patrick.Franzese@greatheartsnorthernoaks.org.

Again, each day's lesson is designed to take no more than 20 minutes. If you have spent more than 20 minutes on a lesson and/or you do not have access to a computer or the internet, then have your parent sign the page next to the "student expectation" section under each lesson and you will receive full credit for the assignment.

Academic Honesty

I certify that I completed this assignment independently in accordance with the GHNO Academy Honor Code.

Student signature:

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I certify that my student completed this assignment independently in accordance with the GHNO Academy Honor Code.

Parent signature:

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Monday, April 13: ***Scheduled Day Off***

Tuesday, April 14 – Lesson: Trade

Objective: Be able to do this by the end of this lesson.
1. Explain the origin and meaning of Adam Smith's "the invisible hand"
2. Identify Adam Smith's arguments for when trade restrictions are permissible

Student Expectations: Annotate the readings, watch the video and answer the questions.

Introduction to Lesson
This week builds upon on previous exploration of the rise of capitalism. As we developed last week, people produce goods/services for trade out of their own self-interest; they want to improve their own lives. When people engage in a voluntary exchange of goods/services, both people benefit and both people become wealthier. Smith, as well as Ricardo, take this idea and demonstrate that countries who pursue free trade increase their wealth as well. If you recall, Smith is writing his book to demonstrate that mercantilism—the idea that countries gain wealth by limiting imports and expanding exports—is flawed and limits wealth creation. Nonetheless, the debate between those who believe in free trade and those who believe trade should be restricted to protect local/national businesses, industries and/or interests still rages today. The first three lessons this week will explore arguments regarding when trade should be restricted.

Trade Restrictions:
Before we delve into the subject it is important to ensure we have a common understanding on how government action can influence international trade. Below are the key ones.

1) Tariffs – tariffs are simply taxes that imposed in imports to make them more costly, and thus less attractive, to buy.

2) Quotas – countries will limit the quantity of a certain product that can be imported. Sometimes the number will be zero!

3) Subsidies – money given by the government to a certain business/industry so they can produce certain items and/or make them cheaper, and thus more attractive, to buy

4) Health and Safety Rules on Imports – for example, the government can say that no sweaters made by children can be imported. This is stealthy way to make foreign goods more expensive and/or restrict their import.

5) Manipulate currency to influence exchange rate:
    a. Stronger dollar makes exports more expensive and imports less expensive
    b. Weaker dollar makes imports more expensive and exports less expensive

    Ex. Look at a piano made in United States that costs $1000 and a car made in Germany at 1000 Euros.

    - If $1 = 1 Euro, then
        - a German can buy the piano for 1,000 Euros
        - an American can buy the car for $1,000
    - If $1 = 2 Euros, then
        - a German can buy the piano for 2,000 Euros
        - an American can buy the car for $500
    - If $1 = .5 Euros, then
        - a German can buy the piano for 500 Euros
        - an American can buy the car for $2,000

Note, with a stronger dollar, while exports will be more expensive, it invites more investment because the returns are greater!

Invisible Hand
Read/annotate in your reader pg 112-114 (end at the end of the 1st paragraph "…be diminished by every such regulation." Then answer the following question(s)?

1) What is the impact of tariffs? Who is harmed and who benefits? Why?

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2) What is the "invisible hand"? What does it do? Why is this significant?

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Book IV, Chapter II

For the remainder of today's lesson, you have the option of doing ***one of the following***. You can do both also! Either way, you need to answer the question that follow lesson.
1. View the following video (7:45) https://www.youtube.com/watch?v=FSSiA0GlyrY ***OR***
2. Read/Annotate pgs 114-121 of your reader

3) Under what conditions does Adam Smith believe it permissible to restrict trade?

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Wednesday, April 15 and Thursday, April 16 - Lesson: Trade

Objective: Be able to do this by the end of this lesson.
Explain why barriers to free trade are often harmful and when they are needed

Student Expectations: Annotate the reading and answer the questions.

Introduction to Lesson(s)
As stated in the last lesson, the debate between those who believe in free trade and those who believe trade should be restricted to protect local/national businesses, industries and/or interests still rages today. In fact, the current pandemic has raised the question of when international trade might harm a country and under what conditions a country should impose trade barriers in order to protect and/or nurture a business or industry. Over the next two days, we will be exploring the major arguments in favor of restricting free trade or, to put it more precisely, an evaluation of those arguments in favor of restricting free trade put forth by Milton Friedman. Milton Friedman is arguably the biggest advocate of free markets in the 20th Century. He was a prolific writer and commentator whose research, reasoning and rationale are still relevant today. The following excerpt is taken from Friedman's book, which he co-wrote with his wife, *Free to Choose.* Given the excerpt is a little long, both reading/annotating the excerpt and answering the questions below should take you approximately 40 minutes combined and thus will cover two lesson days. Begin your reading on the next page under the heading "International Trade" and stop when you get to "Central Economic Planning" on page 20.

be if they were all eliminated. We lose far more from measures that serve other "special interests" than we gain from measures that serve our "special interest."

The clearest example is in international trade. The gains to some producers from tariffs and other restrictions are more than offset by the loss to other producers and especially to consumers in general. Free trade would not only promote our material welfare, it would also foster peace and harmony among nations and spur domestic competition.

Controls on foreign trade extend to domestic trade. They become intertwined with every aspect of economic activity. Such controls have often been defended, particularly for underdeveloped countries, as essential to provide development and progress. A comparison of the experience of Japan after the Meiji Restoration in 1867 and of India after independence in 1947 tests this view. It suggests, as do other examples, that free trade at home and abroad is the best way that a poor country can promote the well-being of its citizens.

The economic controls that have proliferated in the United States in recent decades have not only restricted our freedom to use our economic resources, they have also affected our freedom of speech, of press, and of religion.

INTERNATIONAL TRADE

It is often said that bad economic policy reflects disagreement among the experts; that if all economists gave the same advice, economic policy would be good. Economists often do disagree, but that has not been true with respect to international trade. Ever since Adam Smith there has been virtual unanimity among economists, whatever their ideological position on other issues, that international free trade is in the best interest of the trading countries and of the world. Yet tariffs have been the rule. The only major exceptions are nearly a century of free trade in Great Britain after the repeal of the Corn Laws in 1846, thirty years of free trade in Japan after the Meiji Restoration, and free trade in Hong Kong today. The United States had tariffs throughout the nineteenth century and they were raised still higher in the

twentieth century, especially by the Smoot-Hawley tariff bill of 1930, which some scholars regard as partly responsible for the severity of the subsequent depression. Tariffs have since been reduced by repeated international agreements, but they remain high, probably higher than in the nineteenth century, though the vast changes in the kinds of items entering international trade make a precise comparison impossible.

Today, as always, there is much support for tariffs—euphemistically labeled "protection," a good label for a bad cause. Producers of steel and steelworkers' unions press for restrictions on steel imports from Japan. Producers of TV sets and their workers lobby for "voluntary agreements" to limit imports of TV sets or components from Japan, Taiwan, or Hong Kong. Producers of textiles, shoes, cattle, sugar—they and myriad others complain about "unfair" competition from abroad and demand that government do something to "protect" them. Of course, no group makes its claim on the basis of naked self-interest. Every group speaks of the "general interest," of the need to preserve jobs or to promote national security. The need to strengthen the dollar vis-a-vis the mark or the yen has more recently joined the traditional rationalizations for restrictions on imports.

The Economic Case for Free Trade

One voice that is hardly ever raised is the consumer's. So-called consumer special interest groups have proliferated in recent years. But you will search the news media, or the records of congressional hearings in vain, to find any record of their launching a concentrated attack on tariffs or other restrictions on imports, even though consumers are major victims of such measures. The self-styled consumer advocates have other concerns—as we shall see in Chapter 7.

The individual consumer's voice is drowned out in the cacophony of the "interested sophistry of merchants and manufacturers" and their employees. The result is a serious distortion of the issue. For example, the supporters of tariffs treat it as self-evident that the creation of jobs is a desirable end, in and of itself, regardless of what the persons employed do. That is clearly wrong. If all we

want are jobs, we can create any number—for example, have people dig holes and then fill them up again, or perform other useless tasks. Work is sometimes its own reward. Mostly, however, it is the price we pay to get the things we want. Our real objective is not just jobs but productive jobs—jobs that will mean more goods and services to consume.

Another fallacy seldom contradicted is that exports are good, imports bad. The truth is very different. We cannot eat, wear, or enjoy the goods we send abroad. We eat bananas from Central America, wear Italian shoes, drive German automobiles, and enjoy programs we see on our Japanese TV sets. Our gain from foreign trade is what we import. Exports are the price we pay to get imports. As Adam Smith saw so clearly, the citizens of a nation benefit from getting as large a volume of imports as possible in return for its exports, or equivalently, from exporting as little as possible to pay for its imports.

The misleading terminology we use reflects these erroneous ideas. "Protection" really means exploiting the consumer. A "favorable balance of trade" really means exporting more than we import, sending abroad goods of greater total value than the goods we get from abroad. In your private household, you would surely prefer to pay less for more rather than the other way around, yet that would be termed an "unfavorable balance of payments" in foreign trade.

The argument in favor of tariffs that has the greatest emotional appeal to the public at large is the alleged need to protect the high standard of living of American workers from the "unfair" competition of workers in Japan or Korea or Hong Kong who are willing to work for a much lower wage. What is wrong with this argument? Don't we want to protect the high standard of living of our people?

The fallacy in this argument is the loose use of the terms "high" wage and "low" wage. What do high and low wages mean? American workers are paid in dollars; Japanese workers are paid in yen. How do we compare wages in dollars with wages in yen? How many yen equal a dollar? What determines that exchange rate?

Consider an extreme case. Suppose that, to begin with, 360 yen

equal a dollar. At this exchange rate, the actual rate of exchange for many years, suppose that the Japanese can produce and sell everything for fewer dollars than we can in the United States—TV sets, automobiles, steel, and even soybeans, wheat, milk, and ice cream. If we had free international trade, we would try to buy all our goods from Japan. This would seem to be the extreme horror story of the kind depicted by defenders of tariffs—we would be flooded with Japanese goods and could sell them nothing.

Before throwing up your hands in horror, carry the analysis one step further. How would we pay the Japanese? We would offer them dollar bills. What would they do with the dollar bills? We have assumed that at 360 yen to the dollar everything is cheaper in Japan, so there is nothing in the U.S. market that they would want to buy. If the Japanese exporters were willing to burn or bury the dollar bills, that would be wonderful for us. We would get all kinds of goods for green pieces of paper that we can produce in great abundance and very cheaply. We would have the most marvelous export industry conceivable.

Of course, the Japanese would not in fact sell us useful goods in order to get useless pieces of paper to bury or burn. Like us, they want to get something real in return for their work. If all goods were cheaper in Japan than in the United States at 360 yen to the dollar, the exporters would try to get rid of their dollars, would try to sell them for 360 yen to the dollar in order to buy the cheaper Japanese goods. But who would be willing to buy the dollars? What is true for the Japanese exporter is true for everyone in Japan. No one will be willing to give 360 yen in exchange for one dollar if 360 yen will buy more of everything in Japan than one dollar will buy in the United States. The exporters, on discovering that no one will buy their dollars at 360 yen, will offer to take fewer yen for a dollar. The price of the dollar in terms of yen will go down—to 300 yen for a dollar, or 250 yen, or 200 yen. Put the other way around, it will take more and more dollars to buy a given number of Japanese yen. Japanese goods are priced in yen, so their price in dollars will go up. Conversely, U.S. goods are priced in dollars, so the more dollars the Japanese get for a given number of yen, the cheaper U.S. goods become to the Japanese in terms of yen.

The price of the dollar in terms of yen would fall until, on the average, the dollar value of goods that the Japanese buy from the United States roughly equaled the dollar value of goods that the United States buys from Japan. At that price everybody who wanted to buy yen for dollars would find someone who was willing to sell him yen for dollars.

The actual situation is, of course, more complicated than this hypothetical example. Many nations, and not merely the United States and Japan, are engaged in trade, and the trade often takes roundabout directions. The Japanese may spend some of the dollars they earn in Brazil, the Brazilians in turn may spend those dollars in Germany, and the Germans in the United States, and so on in endless complexity. However, the principle is the same. People, in whatever country, want dollars primarily to buy useful items, not to hoard.

Another complication is that dollars and yen are used not only to buy goods and services from other countries but also to invest and make gifts. Throughout the nineteenth century the United States had a balance of payments deficit almost every year—an "unfavorable" balance of trade that was good for everyone. Foreigners wanted to invest capital in the United States. The British, for example, were producing goods and sending them to us in return for pieces of paper—not dollar bills, but bonds promising to pay back a sum of money at a later time plus interest. The British were willing to send us their goods because they regarded those bonds as a good investment. On the average, they were right. They received a higher return on their savings than was available in any other way. We, in turn, benefited by foreign investment that enabled us to develop more rapidly than we could have developed if we had been forced to rely solely on our own savings.

In the twentieth century the situation was reversed. U.S. citizens found that they could get a higher return on their capital by investing abroad than they could at home. As a result the United States sent goods abroad in return for evidence of debt—bonds and the like. After World War II, the U.S. government made gifts abroad in the form of the Marshall Plan and other foreign aid programs. We sent goods and services abroad as an expression of our belief that we were thereby contributing to a more peaceful

world. These government gifts supplemented private gifts—from charitable groups, churches supporting missionaries, individuals contributing to the support of relatives abroad, and so on.

None of these complications alters the conclusion suggested by the hypothetical extreme case. In the real world, as well as in that hypothetical world, there can be no balance of payments problem so long as the price of the dollar in terms of the yen or the mark or the franc is determined in a free market by voluntary transactions. It is simply not true that high-wage American workers are, as a group, threatened by "unfair" competition from low-wage foreign workers. Of course, particular workers may be harmed if a new or improved product is developed abroad, or if foreign producers become able to produce such products more cheaply. But that is no different from the effect on a particular group of workers of other American firms' developing new or improved products or discovering how to produce at lower costs. That is simply market competition in practice, the major source of the high standard of life of the American worker. If we want to benefit from a vital, dynamic, innovative economic system, we must accept the need for mobility and adjustment. It may be desirable to ease these adjustments, and we have adopted many arrangements, such as unemployment insurance, to do so, but we should try to achieve that objective without destroying the flexibility of the system—that would be to kill the goose that has been laying the golden eggs. In any event, whatever we do should be evenhanded with respect to foreign and domestic trade.

What determines the items it pays us to import and to export? An American worker is currently more productive than a Japanese worker. It is hard to determine just how much more productive—estimates differ. But suppose he is one and a half times as productive. Then, on average, the American's wages would buy about one and a half times as much as a Japanese worker's wages. It is wasteful to use American workers to do anything at which they are less than one and a half times as efficient as their Japanese counterparts. In the economic jargon coined more than 150 years ago, that is the *principle of comparative advantage.* Even if we were more efficient than the Japanese at producing everything, it would not pay us to produce everything. We should concentrate

on doing those things we do best, those things where our superiority is the greatest.

As a homely illustration, should a lawyer who can type twice as fast as his secretary fire the secretary and do his own typing? If the lawyer is twice as good a typist but five times as good a lawyer as his secretary, both he and the secretary are better off if he practices law and the secretary types letters.

Another source of "unfair competition" is said to be subsidies by foreign governments to their producers that enable them to sell in the United States below cost. Suppose a foreign government gives such subsidies, as no doubt some do. Who is hurt and who benefits? To pay for the subsidies the foreign government must tax its citizens. They are the ones who pay for the subsidies. U.S. consumers benefit. They get cheap TV sets or automobiles or whatever it is that is subsidized. Should we complain about such a program of reverse foreign aid? Was it noble of the United States to send goods and services as gifts to other countries in the form of Marshall Plan aid or, later, foreign aid, but ignoble for foreign countries to send us gifts in the indirect form of goods and services sold to us below cost? The citizens of the foreign government might well complain. They must suffer a lower standard of living for the benefit of American consumers and of some of their fellow citizens who own or work in the industries that are subsidized. No doubt, if such subsidies are introduced suddenly or erratically, that will adversely affect owners and workers in U.S. industries producing the same products. However, that is one of the ordinary risks of doing business. Enterprises never complain about unusual or accidental events that confer windfall gains. The free enterprise system is *a profit* and *loss* system. As already noted, any measures to ease the adjustment to sudden changes should be applied evenhandedly to domestic and foreign trade.

In any event, disturbances are likely to be temporary. Suppose that, for whatever reason, Japan decided to subsidize steel very heavily. If no additional tariffs or quotas were imposed, imports of steel into the United States would go up sharply. That would drive down the price of steel in the United States and force steel producers to cut their output, causing unemployment in the steel industry. On the other hand, products made of steel could be

purchased more cheaply. Buyers of such products would have extra money to spend on other things. The demand for other items would go up, as would employment in enterprises producing those items. Of course, it would take time to absorb the now unemployed steelworkers. However, to balance that effect, workers in other industries who had been unemployed would find jobs available. There need be no net loss of employment, and there would be a gain in output because workers no longer needed to produce steel would be available to produce something else.

The same fallacy of looking at only one side of the issue is present when tariffs are urged in order to add to employment. If tariffs are imposed on, say, textiles, that will add to output and employment in the domestic textile industry. However, foreign producers who no longer can sell their textiles in the United States earn fewer dollars. They will have less to spend in the United States. Exports will go down to balance decreased imports. Employment will go up in the textile industry, down in the export industries. And the shift of employment to less productive uses will reduce total output.

The national security argument that a thriving domestic steel industry, for example, is needed for defense has no better basis. National defense needs take only a small fraction of total steel used in the United States. And it is inconceivable that complete free trade in steel would destroy the U.S. steel industry. The advantages of being close to sources of supply and fuel and to the market would guarantee a relatively large domestic steel industry. Indeed, the need to meet foreign competition, rather than being sheltered behind governmental barriers, might very well produce a stronger and more efficient steel industry than we have today.

Suppose the improbable did happen. Suppose it did prove cheaper to buy *all* our steel abroad. There are alternative ways to provide for national security. We could stockpile steel. That is easy, since steel takes relatively little space and is not perishable. We could maintain some steel plants in mothballs, the way we maintain ships, to go into production in case of need. No doubt there are still other alternatives. Before a steel company decides to build a new plant, it investigates alternative ways of doing so, alternative locations, in order to choose the most efficient and eco-

nomical. Yet in all its pleas for subsidies on national security grounds, the steel industry has never presented cost estimates for alternative ways of providing national security. Until they do, we can be sure the national security argument is a rationalization of industry self-interest, not a valid reason for the subsidies.

No doubt the executives of the steel industry and of the steel labor unions are sincere when they adduce national security arguments. Sincerity is a much overrated virtue. We are all capable of persuading ourselves that what is good for us is good for the country. We should not complain about steel producers making such arguments, but about letting ourselves be taken in by them.

What about the argument that we must defend the dollar, that we must keep it from falling in value in terms of other currencies—the Japanese yen, the German mark, or the Swiss franc? That is a wholly artificial problem. If foreign exchange rates are determined in a free market, they will settle at whatever level will clear the market. The resulting price of the dollar in terms of the yen, say, may temporarily fall below the level justified by the cost in dollars and yen respectively of American and Japanese goods. If so, it will give persons who recognize that situation an incentive to buy dollars and hold them for a while in order to make a profit when the price goes up. By lowering the price in yen of American exports to Japanese, it will stimulate American exports; by raising the price in dollars of Japanese goods, it will discourage imports from Japan. These developments will increase the demand for dollars and so correct the initially low price. The price of the dollar, if determined freely, serves the same function as all other prices. It transmits information and provides an incentive to act on that information because it affects the incomes that participants in the market receive.

Why then all the furor about the "weakness" of the dollar? Why the repeated foreign exchange crises? The proximate reason is because foreign exchange rates have not been determined in a free market. Government central banks have intervened on a grand scale in order to influence the price of their currencies. In the process they have lost vast sums of their citizens' money (for the United States close to $2 billion from 1973 to early 1979). Even more important, they have prevented this important set of

prices from performing its proper function. They have not been able to prevent the basic underlying economic forces from ultimately having their effect on exchange rates, but have been able to maintain artificial exchange rates for substantial intervals. The effect has been to prevent gradual adjustment to the underlying forces. Small disturbances have accumulated into large ones, and ultimately there has been a major foreign exchange "crisis."

Why have governments intervened in foreign exchange markets? Because foreign exchange rates reflect internal policies. The U.S. dollar has been weak compared to the Japanese yen, the German mark, and the Swiss franc primarily because inflation has been much higher in the United States than in the other countries. Inflation meant that the dollar was able to buy less and less at home. Should we be surprised that it has also been able to buy less abroad? Or that Japanese or Germans or Swiss should not be willing to exchange as many of their own currency units for a dollar? But governments, like the rest of us, go to great lengths to try to conceal or offset the undesirable consequences of their own policies. A government that inflates is therefore led to try to manipulate the foreign exchange rate. When it fails, it blames internal inflation on the decline in the exchange rate, instead of acknowledging that cause and effect run the other way.

In all the voluminous literature of the past several centuries on free trade and protectionism, only three arguments have ever been advanced in favor of tariffs that even in principle may have some validity.

First is the national security argument already mentioned. Although that argument is more often a rationalization for particular tariffs than a valid reason for them, it cannot be denied that on occasion it might justify the maintenance of otherwise uneconomical productive facilities. To go beyond this statement of possibility and establish in a specific case that a tariff or other trade restriction is justified in order to promote national security, it would be necessary to compare the cost of achieving the specific security objective in alternative ways and establish at least *a prima facie* case that a tariff is the least costly way. Such cost comparisons are seldom made in practice.

The second is the "infant industry" argument advanced, for

example, by Alexander Hamilton in his *Report on Manufactures*. There is, it is said, a potential industry which, if once established and assisted during its growing pains, could compete on equal terms in the world market. A temporary tariff is said to be justified in order to shelter the potential industry in its infancy and enable it to grow to maturity, when it can stand on its own feet. Even if the industry could compete successfully once established, that does not of itself justify an initial tariff. It is worthwhile for consumers to subsidize the industry initially—which is what they in effect do by levying a tariff—only if they will subsequently get back at least that subsidy in some other way, through prices later lower than the world price, or through some other advantages of having the industry. But in that case, is a subsidy needed? Will it then not pay the original entrants into the industry to suffer initial losses in the expectation of being able to recoup them later? After all, most firms experience losses in their early years, when they are getting established. That is true if they enter a new industry or if they enter an existing one. Perhaps there may be some special reason why the original entrants cannot recoup their initial losses even though it be worthwhile for the community at large to make the initial investment. But surely the presumption is the other way.

The infant industry argument is a smoke screen. The so-called infants never grow up. Once imposed, tariffs are seldom eliminated. Moreover, the argument is seldom used on behalf of true unborn infants that might conceivably be born and survive if given temporary protection. They have no spokesmen. It is used to justify tariffs for rather aged infants that can mount political pressure.

The third argument for tariffs that cannot be dismissed out of hand is the "beggar-thy-neighbor" argument. A country that is a major producer of a product, or that can join with a small number of other producers that together control a major share of production, may be able to take advantage of its monopoly position by raising the price of the product (the OPEC cartel is the obvious current example). Instead of raising the price directly, the country can do so indirectly by imposing an export tax on the product—an export tariff. The benefit to itself will be less than

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the cost to others, but from the national point of view, there can be a gain. Similarly, a country that is the primary purchaser of a product—in economic jargon, has monopsony power—may be able to benefit by driving a hard bargain with the sellers and imposing an unduly low price on them. One way to do so is to impose a tariff on the import of the product. The net return to the seller is the price less the tariff, which is why this can be equivalent to buying at a lower price. In effect, the tariff is paid by the foreigners (we can think of no actual example). In practice this nationalistic approach is highly likely to promote retaliation by other countries. In addition, as for the infant industry argument, the actual political pressures tend to produce tariff structures that do not in fact take advantage of any monopoly or monopsony positions.

A fourth argument, one that was made by Alexander Hamilton and continues to be repeated down to the present, is that free trade would be fine if all other countries practiced free trade but that so long as they do not, the United States cannot afford to. This argument has no validity whatsoever, either in principle or in practice. Other countries that impose restrictions on international trade do hurt us. But they also hurt themselves. Aside from the three cases just considered, if we impose restrictions in turn, we simply add to the harm to ourselves and also harm them as well. Competition in masochism and sadism is hardly a prescription for sensible international economic policy! Far from leading to a reduction in restrictions by other countries, this kind of retaliatory action simply leads to further restrictions.

We are a great nation, the leader of the free world. It ill behooves us to require Hong Kong and Taiwan to impose export quotas on textiles to "protect" our textile industry at the expense of U.S. consumers and of Chinese workers in Hong Kong and Taiwan. We speak glowingly of the virtues of free trade, while we use our political and economic power to induce Japan to restrict exports of steel and TV sets. We should move unilaterally to free trade, not instantaneously, but over a period of, say, five years, at a pace announced in advance.

Few measures that we could take would do more to promote the cause of freedom at home and abroad than complete free

trade. Instead of making grants to foreign governments in the name of economic aid—thereby promoting socialism—while at the same time imposing restrictions on the products they produce—thereby hindering free enterprise—we could assume a consistent and principled stance. We could say to the rest of the world: we believe in freedom and intend to practice it. We cannot force you to be free. But we can offer full cooperation on equal terms to all. Our market is open to you without tariffs or other restrictions. Sell here what you can and wish to. Buy whatever you can and wish to. In that way cooperation among individuals can be worldwide and free.

The Political Case for Free Trade

Interdependence is a pervasive characteristic of the modern world: in the economic sphere proper, between one set of prices and another, between one industry and another, between one country and another; in the broader society, between economic activity and cultural, social, and charitable activities; in the organization of society, between economic arrangements and political arrangements, between economic freedom and political freedom.

In the international sphere as well, economic arrangements are intertwined with political arrangements. International free trade fosters harmonious relations among nations that differ in culture and institutions just as free trade at home fosters harmonious relations among individuals who differ in beliefs, attitudes, and interests.

In a free trade world, as in a free economy in any one country, transactions take place among private entities—individuals, business enterprises, charitable organizations. The terms at which any transaction takes place are agreed on by all the parties to that transaction. The transaction will not take place unless all parties believe they will benefit from it. As a result, the interests of the various parties are harmonized. Cooperation, not conflict, is the rule.

When governments intervene, the situation is very different. Within a country, enterprises seek subsidies from their government, either directly or in the form of tariffs or other restrictions

on trade. They will seek to evade economic pressures from competitors that threaten their profitability or their very existence by resorting to political pressure to impose costs on others. Intervention by one government in behalf of local enterprises leads enterprises in other countries to seek the aid of their own government to counteract the measures taken by the foreign government. Private disputes become the occasion for disputes between governments. Every trade negotiation becomes a political matter. High government officials jet around the world to trade conferences. Frictions develop. Many citizens of every country are disappointed at the outcome and end up feeling they got the short end of the stick. Conflict, not cooperation, is the rule.

The century from Waterloo to the First World War offers a striking example of the beneficial effects of free trade on the relations among nations. Britain was the leading nation of the world, and during the whole of that century it had nearly complete free trade. Other nations, particularly Western nations, including the United States, adopted a similar policy, if in somewhat diluted form. People were in the main free to buy and sell goods from and to anyone, wherever he lived, whether in the same or a different country, at whatever terms were mutually agreeable. Perhaps even more surprising to us today, people were free to travel all over Europe and much of the rest of the world without a passport and without repeated customs inspection. They were free to emigrate and in much of the world, particularly the United States, free to enter and become residents and citizens.

As a result, the century from Waterloo to the First World War was one of the most peaceful in human history among Western nations, marred only by some minor wars—the Crimean War and the Franco-Prussian Wars are the most memorable—and, of course, a major civil war within the United States, which itself was a result of the major respect—slavery--in which the United States departed from economic and political freedom.

In the modern world, tariffs and similar restrictions on trade have been one source of friction among nations. But a far more troublesome source has been the far-reaching intervention of the state into the economy in such collectivist states as Hitler's Germany, Mussolini's Italy, and Franco's Spain, and especially the

communist countries, from Russia and its satellites to China. Tariffs and similar restrictions distort the signals transmitted by the price system, but at least they leave individuals free to respond to those distorted signals. The collectivist countries have introduced much farther-reaching command elements.

Completely private transactions are impossible between citizens of a largely market economy and of a collectivist state. One side is necessarily represented by government officials. Political considerations are unavoidable, but friction would be minimized if the governments of market economies permitted their citizens the maximum possible leeway to make their own deals with collectivist governments. Trying to use trade as a political weapon or political measures as a means to increase trade with collectivist countries only makes the inevitable political frictions even worse.

Free International Trade and Internal Competition

The extent of competition at home is closely related to international trade arrangements. A public outcry against "trusts" and "monopolies" in the late nineteenth century led to the establishment of the Interstate Commerce Commission and the adoption of the Sherman Anti-Trust Law, later supplemented by many other legislative actions to promote competition. These measures have had very mixed effects. They have contributed in some ways to increased competition, but in others they have had perverse effects.

But no such measure, even if it lived up to every expectation of its sponsors, could do as much to assure effective competition as the elimination of all barriers to international trade. The existence of only three major automobile producers in the United States—and one of those on the verge of bankruptcy—does raise a threat of monopoly pricing. But let the automobile producers *of the world* compete with General Motors, Ford, and Chrysler for the custom of the American buyer, and the specter of monopoly pricing disappears.

So it is throughout. A monopoly can seldom be established within a country without overt and covert government assistance in the form of a tariff or some other device. It is close to impossible to do so on a world scale. The De Beers diamond monop-

oly is the only one we know of that appears to have succeeded. We know of no other that has been able to exist for long without the direct assistance of governments—the OPEC cartel and earlier rubber and coffee cartels being perhaps the most prominent examples. And most such government-sponsored cartels have not lasted long. They have broken down under the pressure of international competition—a fate that we believe awaits OPEC as well. In a world of free trade, international cartels would disappear even more quickly. Even in a world of trade restrictions, the United States, by free trade, unilateral if necessary, could come close to eliminating any danger of significant internal monopolies.

CENTRAL ECONOMIC PLANNING

Traveling in underdeveloped countries, we have over and over again been deeply impressed by the striking contrast between the ideas about facts held by the intellectuals of those countries and many intellectuals in the West, and the facts themselves.

Intellectuals everywhere take for granted that free enterprise capitalism and a free market are devices for exploiting the masses, while central economic planning is the wave of the future that will set their countries on the road to rapid economic progress. We shall not soon forget the tongue-lashing one of us received from a prominent, highly successful, and extremely literate Indian entrepreneur—physically the very model of the Marxist caricature of an obese capitalist—in reaction to remarks that he correctly interpreted as criticism of India's detailed central planning. He informed us in no uncertain terms that the government of a country as poor as India simply had to control imports, domestic production, and the allocation of investment—and by implication grant him the special privileges in all these areas that are the source of his own affluence—in order to assure that *social* priorities override the selfish demands of individuals. And he was simply echoing the views of the professors and other intellectuals in India and elsewhere.

The facts themselves are very different. Wherever we find any large element of individual freedom, some measure of progress in the material comforts at the disposal of ordinary citizens, and

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1) Is ensuring a "favorable balance of trade" (i.e., making sure you export more than you import) a meaningful policy goal?

2) What are the three arguments in favor of tariffs that Friedman believes may have validity? How does Friedman respond to them?

3) Which do you believe is the strongest argument Friedman discusses? Why?

4) Which do you believe is the strongest argument in light of the current pandemic? Why?

5) According to Friedman, how does free trade help protect against monopolies?

Concluding Thought

As you can imagine, proponents of imposing trade restrictions typically argue that those restrictions are needed for national security. How far is this stretched? Would you be surprised to learn protecting our sugar industry is a national security concern? If you have time, search the internet using the terms "sugar" and "national security" and see what you find!

Friday, Apri1 17 - Lesson: Basic Economic Questions

Objective: Be able to do this by the end of this lesson.
1. List the basic economic questions each society must face
2. Identify the ways a society can organize its economy to answer these questions
3. Identify how the United States organizes its economy to answer these questions

Lesson Student Expectations: Read/annotate below, search using the links below and answer the questions. ***Take Quiz on page 25 after completing this lesson!***

Introduction to Lesson
We have finished the block that discusses the rise of capitalism where we examined at the factors that contributed to the rise of capitalism, the definition of capitalism, and the core characteristic of capitalism of allowing individuals to pursuing their own self-interest which leads to both more efficiency (i.e., division of labor) as well as the creation of wealth through trade. In this next block, we will examine the ways societies can arrange themselves economically, how non-capitalistic societies have fared and what flaw prevents them from succeeding, and the significant role economic freedom had in the founding of the United States.

Basic Economic Questions Every Society Faces
We started this course by discussing the concept of scarcity which is defined as "having unlimited wants and needs in a world with limited resources." There is not getting around the issues of scarcity. Every society confronts the problem of how to make the best use of limited resources to satisfy human needs and wants—i.e. how to allocate scarce resources. In short, every society must answer the following questions

1) What goods and services should be produced?
2) How many of each type of goods and services should be produced?
3) How should goods and services be produced
4) Who should produce them (i.e., who owns and controls the factors of production)?
5) For whom should they produced?

Main Types of Economies
In order to answer these questions, society have adopted four main types of economies.

1) Traditional Economy
2) Command Economy
3) Market Economy
4) Mixed Economy

Characteristics of a Traditional Economy
1) *Traditional economies center around a family or tribe.* They use traditions gained from the elders' experiences to guide day-to-day life and economic decisions.
2) *A traditional economy exists in a hunter-gatherer and nomadic society.* These societies cover vast areas to find enough food to support them. They follow the herds of animals that sustain them, migrating with the seasons. These nomadic hunter-gatherers compete with other groups for

scarce natural resources. There is little need for trade since they all consume and produce the same things.
3) *Most traditional economies produce only what they need.* There is rarely surplus or leftovers. That makes it unnecessary to trade or create money.
4) *When traditional economies do trade, they rely on barter.* It can only occur between groups that don't compete. For example, a tribe that relies on hunting exchanges food with a group that relies on fishing. Because they just trade meat for fish, there is no need for cumbersome currency.
5) *Traditional economies start to evolve once they start farming and settle down.* They are more likely to have a surplus, such as a bumper crop, that they use for trade. When that happens, the groups create some form of money. That facilitates trading over long distances.

Characteristics of a Market Economy

1. *Private Property.* Most goods and services are privately-owned. The owners can make legally-binding contracts to buy, sell, or lease their property. In other words, their assets give them the right to profit from ownership. But U.S. law excludes some assets. Since 1865, you cannot legally buy and sell human beings. That includes you, your body, and your body parts.
2. *Freedom of Choice*. Owners are free to produce, sell, and purchase goods and services in a competitive market. They only have two constraints. First is the price at which they are willing to buy or sell. Second is the amount of capital they have.
3. *Motive of Self-Interest.* Everyone sells their wares to the highest bidder while negotiating the lowest price for their purchases. Although the reason is selfish, it benefits the economy over the long run. This auction system sets prices for goods and services that reflect their market value. It gives an accurate picture of supply and demand at any given moment.
4. *Competition.* The force of competitive pressure keeps prices low. It also ensures that society provides goods and services most efficiently. As soon as demand increases for a particular item, prices rise thanks to the law of demand. Competitors see they can enhance their profit by producing it, adding to supply. That lowers prices to a level where only the best competitors remain. This competitive pressure also applies to workers and consumers. Employees vie with each other for the highest-paying jobs. Buyers compete for the best product at the lowest price. There are three strategies that work to maintain a competitive advantage.
5. *System of Markets and Prices.* A market economy relies on an efficient market in which to sell goods and services. That's where all buyers and sellers have equal access to the same information. Price changes are pure reflections of the laws of supply and demand. There are five determinants of demand.
6. *Limited Government.* The role of government is to ensure that the markets are open and working. For example, it is in charge of national defense to protect the markets. It also makes sure that everyone has equal access to the markets. The government penalizes monopolies that restrict competition. It makes sure no one is manipulating the markets and that everyone has equal access to information.

Five Characteristics of a Command Economy

1. *The government creates a central economic plan.* The five-year plan sets economic and societal goals for every sector and region of the country. Shorter-term plans convert the goals into actionable objectives.

2. *The government allocates all resources according to the central plan.* It tries to use the nation's capital, labor and natural resources in the most efficient way possible. It promises to use each person's skills and abilities to their highest capacity. It seeks to eliminate unemployment.
3. *The central plan sets the priorities for the production of all goods and services.* These include quotas and price controls. Its goal is to supply enough food, housing, and other basics to meet the needs of everyone in the country. It also sets national priorities. These include mobilizing for war or generating robust economic growth.
4. *The government owns monopoly businesses.* These are in industries deemed essential to the goals of the economy. That usually includes finance, utilities, and automotive. There is no domestic competition in these sectors.
5. *The government creates laws, regulations, and directives to enforce the central plan.* Businesses follow the plan's production and hiring targets. They can't respond on their own to free market forces.

Mixed Economy

A mixed economy is a system that combines characteristics of market and command economies. ***The United States and most countries of the world are Mixed Economies. Some, like the US, are primarily Market Economies that have some command elements. Others, like China, are primarily Command Economies that have adopted some free market principles***

Summary Questions

1. What are the basic economic questions each society must answer?

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2. List the characteristics of a command economy:

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3. List the characteristics of a market economy:

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4. Why type of economy is the United States? ______________________________________

*****Check answers to summary questions before taking the quiz!*****

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Quiz – Week of April 13
(Complete without looking at your notes or packet!)

1. In discussing trade, Adam Smith writes "He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by ____________to promote an end which was no part of his intention."
   a. Greed
   b. Self-Interest
   c. An Invisible Hand
   d. Government Regulation

2. What does the quote in question #1 mean?

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3. Who do tariffs usually help (i.e., who profits from a tariff)? Why?

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5. Who do tariffs usually harm (i.e., who suffers economic harm from a tariff? Why?

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6. The United States is a:
   a. Market Economy
   b. Mixed Economy
   c. Traditional Economy
   d. Command Economy

7. Which of the following is NOT a basic economic question each society must ask:
   a. What goods and services, and how much of each, should be produced?
   b. Who should produce the goods and services?
   c. Why should the goods and services be produced?
   d. For whom should the goods and services be produced?

(One more question on next page!!)

8. Identify each characteristic below as either Traditional (“T”), Command (“C”) and Market (“M”) economy.

__ Produce only what they need

__ The central plan sets the priorities for the production of all goods and services

__ Rely on barter

__ Freedom of Choice

__ The government creates a central economic plan

__ The government creates laws, regulations, and directives to enforce the central plan

__ Limited Government

__ Competition