



Nexus: Connections Between Economics and Civics



National Council on Economic Education

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Page	
5	Nexus: Connections between Economics and Civics
5	Foreword
5	Description and Rationale
5	<i>Nexus: a connected group or series</i>
6	Viewpoint
8	Nexus Points and Organization
8	<i>Nexus Statements</i>
10	<i>Order of Nexus Points</i>
10	<i>Economic Lessons</i>
11	NEXUS
11	Rights
11	Nexus Statement
11	Rationale Statement
12	Standards
13	Benchmarks
13	Content Summary
13	<i>Natural Rights</i>
14	<i>Constitutional Rights</i>
15	<i>Rights' Protection and Implementation</i>
15	<i>How Different Countries View Rights Differently</i>
16	<i>Rights and Economic Security</i>
16	<i>Why Some Economic Rights Are Controversial</i>
17	<i>Rights and National Security</i>
17	<i>Rights and Tradeoffs</i>
18	Enduring Issues
19	Public Policy Question
19	Economics Lessons
21	Institutions
21	Nexus Statement
21	Rationale Statement
21	Standards
21	Benchmarks
22	Content Summary
23	<i>Economic Institutions</i>
24	<i>Institutions that Define Property Rights: The United States Trademark and Patent Office</i>
24	<i>Recording and Defining Intellectual Property Rights Patents, Trademarks, and Copyrights</i>
24	<i>Trademarks</i>
25	Enduring Issues
25	Public Policy Question
26	Economics Lessons
28	Efficiency
28	Nexus Statement
28	Rationale Statement
28	Standards
29	Benchmarks
29	Content Summary
29	<i>Efficiency in the Economy</i>
30	<i>Efficiency in Government</i>
32	Enduring Issues
32	Public Policy Question
33	Economics Lessons
34	Decision Making
34	Nexus Statement
34	Rationale Statement
34	Standards
35	Benchmarks
35	Content Summary

36	<i>Decision Making and Tradeoffs</i>
37	<i>Marginalism</i>
38	Enduring Issues
38	Public Policy Question
38	Economics Lessons
40	Stability
40	Nexus Statement
40	Rationale Statement
40	Standards
41	Benchmarks
41	Content Summary
41	<i>Political Stability: Transference of Power</i>
41	<i>Political Stability: Institutional Practice</i>
42	<i>Political Stability: Legal Framework</i>
42	<i>Economic Stability: Dampening the Business Cycle</i>
42	<i>Monetary Policy</i>
44	<i>Fiscal Policy</i>
44	Enduring Issues
45	Public Policy Question
45	Economics Lessons
48	Market and Government Failures
48	Nexus Statement
48	Rationale Statement
48	Standards
48	Benchmarks
49	Content Summary
49	<i>Market Failures</i>
50	<i>Government Failures</i>
53	Enduring Issues
54	Public Policy Question
54	Economics Lessons
58	Regulation
58	Nexus Statement
58	Rationale Statement
58	Standards
59	Benchmarks
59	Content Summary
59	<i>Establishing Standards</i>
60	<i>Regulation to Correct Market Failures</i>
60	<i>Regulatory Agencies</i>
61	<i>Antitrust laws</i>
61	<i>Product and Manufacturing Regulation</i>
62	<i>Deregulation</i>
62	Enduring Issues
62	Public Policy Question
63	Economics Lessons
65	Globalization
65	Nexus Statement
65	Rationale Statement
65	Standards
66	Benchmarks
66	Content Summary
68	<i>Trade barriers</i>
69	<i>Economic Policy and Foreign Policy</i>
69	<i>Sovereignty of the Nation-State in an Increasingly Global World</i>
70	Enduring Issues
71	Public Policy Question
71	Economics Lessons

Nexus: Connections between Economics and Civics

Foreword

The final version of *Nexus* was edited by Steven L. Miller and written by Steven L. Miller, Phillip VanFossen, and Aleks Kvasov. It is a condensed version of an initial draft to which (in addition to the final authors) Margaret Branson, Stephen Schecter, Jack Barlow, and Peter Moore made significant contributions, both in design and writing. The final version was revised and significantly altered based on comments from reviewers, to whom the authors are indebted. The authors acknowledge the extremely helpful comments on this version from Peter Moore and the contribution of James Dick in identifying appropriate economics lessons.

Description and Rationale

*Nexus: a connected group or series*¹

Nexus, a project of the National Council on Economic Education, is an effort to specify the major points of contact between civics and economics. Indeed, economics and civics touch in many places. This is nowhere clearer than in the liberalizing² nations of the former Soviet Union and its satellites. For example, it has become evident that implementation of a market economy depends crucially on the firm establishment of key elements of government, such as the rule of law and well defined property rights. At this writing, the United States and other members of the coalition are attempting to assist the people of Iraq in reconstructing both their political and economic systems. The difficulty of such a task is manifest as is the desperate need for safeguards for human rights, democratic institutions, and the foundations for a market economy.

The experiences of many nations show the interrelationships of liberal democracy³ and a market system.⁴ Thus, the perspectives of economics and civics complement each other, each adding depth to the treatment of particular themes and topics. To take one example, both civics and economics have a great deal to say about human rights and freedom. In this instance, the concepts of one discipline enrich the corresponding concepts of the other. Sometimes, an idea typically associated with one discipline presents useful applications within the other. In some cases, the same terminology refers to quite different ideas. Consider “failures”—civic educators speak of political failures; economic educators of market failures. In sum, there are many points of connection—nexus points—the specification of which produces a vision that is greater than the sum of its parts.

The *Nexus Project* is conceived of as an ongoing effort to create materials useful for educators in many nations, including the United States, to understand better the points of connection between civics and economics. Each “nexus point” references the United States national standards in both economics and civics, drawn from the National Council on Economic Education’s *Voluntary National Content Standards in Economics* and the Center for Civic

Education’s *National Standards for Civics and Government*, respectively. Each nexus point begins with the **nexus statement** as listed later, followed by:

- **Rationale Statement:** A brief overview of the nexus point and why it is significant.
- **Benchmarks:** Statements of what students will be able to do after studying the ideas in a particular nexus point.
- **The relevant United States national standards in civics economics.**
- **Content Summary:** The main explanation of the civic and economic ideas related to this nexus topic.
- **Enduring Issues:** Questions related to the economic and civic ideas that are of continuing interest and that could be used by educators as springboards for student discussion or research projects.
- **Public Policy Question:** A brief case study, real or hypothetical, that serves as a vehicle for further discussion with students of the civic and economic content of the nexus point.
- **Economics lesson links to lessons from the National Council on Economic Education.**

The project is designed to be flexible and grow over time. Others will identify still more nexuses, which can be added. Some potential nexus points, such as one considering “civil society,” were excluded from the present text because there are currently no economics lessons related to the point. Later, if appropriate lessons are found or developed, it might be added. Links to lessons in civics can also be added in the future. This enables the project to grow over time and become both wider and deeper.

Viewpoint

Nexus: Connections between Economics and Civics is written from the point of view of modern liberalism, both political and economic:

“Liberalism is an ideology, philosophy, and political tradition that holds liberty as the primary political value. Broadly speaking, liberalism seeks a society characterized by freedom of thought for individuals, limitations on power, especially of government and religion, the rule of law, the free exchange of ideas, a market economy that supports relatively free private enterprise, and a transparent system of government in which the rights of minorities are guaranteed. In modern society, liberals favour a liberal democracy with open and fair elections, where all citizens have equal rights by law and an equal opportunity to succeed.”⁵

Under liberalism government strives to create a society in which personal liberty is maximized and protected; the greatest good is thus achieved when all members of society are free to live as they wish. Originally, liberalism envisioned the need for government to ensure that the inherent rights of individuals were protected, while the role of government was carefully proscribed. The founders of the United States system of liberal democracy were very concerned about a tyrannical government, and so put in place a structure designed to disperse power. The elements of this structure are familiar to citizens of the United States. Some of

these features include;

- Federalism, that is sovereignty shared by the national and state governments, with the powers of the national government limited by the Constitution to those “enumerated” within the Constitution.
- Checks and balances, where legislative, executive, and judicial power is divided among separate branches of the government, each of which has some authority in overseeing the actions of the other branches.
- Bill of Rights, the first ten amendments to the United States Constitution which specify areas of personal freedom on which government may not infringe.

It is important to note that the rights defined in the Bill of Rights have been thought of as “negative” in the sense that these are inherent freedoms that must be protected *from* action by government—for example, what is commonly referred to as “freedom of speech” is found in Amendment I: “Congress shall make no law...abridging the freedom of speech...” However, modern liberalism has recognized the need to establish “positive” rights, for instance the right to an education.⁶ With the conception of positive rights, the role of government expands. Given the standard that “the greatest good is achieved when all members of society are free to live as they wish,” a case may certainly be made that government should take action in ways that assist citizens to accomplish this. For example, education for everyone at public expense presumably allows many people to pursue avenues in life that otherwise might not have been available. In addition, some view positive rights as a way to “level the playing field,” as in more equal access to education.

Within the framework of modern liberalism, there is room for a spectrum of governmental systems with varying emphases. Liberal democracies have developed differently based on the history and cultures of the respective countries. In general, compared with the United States, governments in Western Europe tend to reflect less concern with the concentration of power of the national government and assume a greater role in the provision of positive rights. Moreover, unlike the American tradition of concern over concentrated government power, many European citizens see government as a bulwark against overly powerful private interests.

This document probably reflects the American orientation of the primary authors, even in the frequent references to such things as the United States Constitution. Nonetheless, educators from other liberal democracies and liberalizing nations should find the ideas applicable to their specific nations. Moreover, the document uses many illustrative examples from countries around the world.

Nexus also reflects the viewpoint that modern liberalism refers to both political and economic liberalism, and that liberal democracy and market systems are philosophically and practically compatible. As Mandelbaum has written:

“The understanding of the world of the twenty-first century that prevails in the core countries—the ‘liberal theory of history’—consists of two propositions. One is that democracies tend to conduct peaceful foreign policies. The other is that where free markets are established, their working, over time, tends to promote democracy.”⁷

It is significant that in the rankings of economic freedom of the various nations of the

world (a reasonable proxy for the existence of a predominantly market system), the top third of the 157 countries rated are virtually all liberal democracies, with a few liberalizing nations among them.⁸ In contrast, the nations that are primarily command economies, where resources are allocated by central planners, are also among the least free politically and least successful economically.

Thus, in the economic sphere, the viewpoint of *Nexus* is that market systems are the primary means of allocating resources within the liberal democracies, and might be for liberalizing nations should their evolution be successful. It is also the fundamental mechanism for the exchange of goods and services among people who live in different countries.

It is fundamental in economics to also focus on the role of government in an economy and the shortcomings of market systems, including what government might do to remedy these problems. This begins with establishing the rule of law as protection against arbitrary actions of government and safeguarding property rights, requirements so basic that no market system can function without them and one of the crucial hurdles for liberalizing nations.⁹ Throughout, *Nexus* devotes attention to many of the reasons why governments intervene in market systems and some of the controversies surrounding such policies.

As is the case in modern political liberalism, there is room for disagreement within modern economic liberalism over how much intervention there should be. For example, European countries tend to provide more social services than does the United States. The diversity among countries reflects differences not only in ideology, but in history, culture, and the decisions about social trade-offs among competing goals.¹⁰ Nonetheless, there is broad consensus about markets as the primary means of organizing economic activity.

Clearly, there are other philosophical viewpoints, or ideologies, and the scholars who hold them will disagree with the fundamental framework of *Nexus*. We have not attempted to include perspectives on the intersection of civics and economics from, for example, libertarian, communitarian, or socialist perspectives. It is not that these perspectives have nothing important to offer educators as they work with students in understanding the connections of civics and economics. Students would benefit from exposure to different theoretical perspectives. Rather, it is simply the case that such a discussion is beyond the scope of this work. The intent of this document is to join civics and economics content relevant to the actual practice of liberal democracies and as described in educational content standards.

Nexus Points and Organization

This section presents this initial set of nexus points, including the *nexus statement*, a brief declaration of what the nexus point is about. Nexus statements are intended to be very brief, indicating the basic intersection of civics and economics. Later, the section presents a few notes on the order in which the nexus points are presented.

Nexus Statements

Rights

That individuals have rights is a basic assumption of the modern theory and practice of liberal democracy. Government has a responsibility to secure citizens' rights. Rights, including but not limited to property rights, are essential to a market-based system.

Institutions

Institutions are arrangements and settled practices that have evolved or been established to perform political and economic functions for the benefit of the whole society or groups within it.

Efficiency

One goal in both a market economy and a democratic society is efficiency. While there are numerous definitions of efficiency, one way to conceive of efficiency is this: for both the economy and political system generally to produce outcomes most desired by citizens.

Decision Making

Economic resources used to produce goods and services are scarce, forcing individuals and governments to make choices about how to use those resources. All choices have costs, and analyzing costs incurred relative to benefits received is an important aspect of decision making in both the marketplace and in the voting booth. Often, both individual and government decision-making involve trade-offs—giving up some of one thing in order to get a little more of something else.

Stability

Liberal democracies seek to maintain stability through both the governmental and economic systems. By stability, we mean both the quality of dependability and the absence of extreme fluctuations in both government and the economy. For example, the governance and economic systems must function dependably and avoid extreme episodes of inflation and recession.

Market and Government Failures

The performance of both market economies and liberal democracies sometimes falls short of the ideal. These shortcomings are often referred to as market or government “failures.”

Regulation

When markets fail to work ideally, government may take an active role in correcting such failures, such as imperfectly competitive markets or the presence of externalities. Often in these cases, government attempts to alter less than ideal economic outcomes through regulatory powers.

Globalization

Today the world is organized into some 200 nation-states, each of which claims its own sovereignty. Nation-states do not exist in isolation—each is part of an interconnected world in whose development it plays a role. The sovereignty of nation-states, however, is being profoundly affected by the emergence of a global economic system, including recent rapid growth of international trade that stretches beyond the control of any single state and exerts economic, technological, and cultural influences on individual nations. Sovereignty also is being particularly affected by recent rapid growth of international trade.

Order of Nexus Points

In general, *Nexus* lays a basic foundation in the first four nexus points, explores aspects of that foundation in the next three, and finally expands to the world stage in the final point. *Nexus* begins with an examination of **Rights**, given the focus of the document on modern liberalism, the primary role of government is safeguarding the rights of citizens, and the central nature of property rights to market systems. Governments establish **Institutions** to enable the political and economic systems to function. **Efficiency** is considered next primarily because of its importance in economics as the test for an economic system and also as a desirable goal of the political system; hence, it also sets the stage for several later nexus points. **Decision Making** presents directly the important idea that efficiency is not the only (nor even necessarily the most important) goal. As with **Efficiency**, it provides context for the three nexus points that follow. **Stability** follows by exploring the implications of this desirable goal in both the political and economic realms. **Market and Government Failures** explores the reasons why liberal democracies and market systems have inadequacies in practice. The role of government in remedying failure is explored in **Regulation**. Finally, **Globalization** presents aspects of the connection of civics and economics in our increasingly globalized world.

Economic Lessons

At the conclusion of each nexus point, several economics lessons are listed. The lessons indicate the original NCEE publication or “*Online*” in the case of those published online as part of the NCEE [EconEdLink](#) site. Some lessons are included in more than one nexus point since the ideas taught in the lesson might be applicable to more than one nexus. Lessons were selected primarily for grades 9-12.

References

- ¹ *The American Heritage College Dictionary*. 4th Edition. (Boston: Houghton Mifflin, 2002).
- ² In general this document uses the term “liberalizing” to mean countries moving toward liberal democracy and a market system. This is in contrast to the term “liberalization,” which is often used to refer to one of the three legs of economic reform in the “Washington consensus:” privatization (of state owned enterprises, for example), stabilization (e.g., getting inflation under control), and liberalization (e.g., deregulating prices).
- ³ The term *liberal democracy* is used in this document to mean governments that are characterized by 1) democracy, either direct or through representatives, and 2) and constitutionalism, including the protection of basic rights. See Neal Reimer, Douglas W. Simon and Joseph Romance. *The Challenge of Politics: An Introduction to Political Science*. Chapter 7 retrieved on April 20, 2003 from <http://www.cqpress.com/cs/challenge/chapter7.htm>.
- ⁴ No modern economy is exclusively based on free markets. In this document, we use the term *market system* to refer to an economy that is *primarily* based on markets.
- ⁵ *Wikipedia*, <http://en.wikipedia.org/wiki/Liberalism> accessed on June 8, 2006
- ⁶ A larger discussion of rights, including negative and positive rights, is found later in this document in the nexus point on “Rights.”
- ⁷ Michael Mandelbaum. *The Ideas That Conquered the World: Peace, Democracy, and Free Markets in the Twenty-First Century*. (New York: Public Affairs, 2003), p. 11.
- ⁸ Heritage Foundation. *2006 Index of Economic Freedom*, <http://www.heritage.org/research/features/index/indexoffreedom.cfm> retrieved on June 8, 2006. Hong Kong and Singapore were the top two listed. Freedom House (<http://www.freedomhouse.org/>) lists both as “partly free” with respect to political rights and civil liberties.
- ⁹ See *Nexus*, “Rights.”
- ¹⁰ See *Nexus*, “Decision Making”

NEXUS

Rights

Nexus Statement

That individuals have rights is a basic assumption of the modern theory and practice of liberal democracy. Government has a responsibility to secure citizens' rights. Rights, including but not limited to property rights, are essential to a market-based system.

Rationale Statement

Rights are claims that individuals have to certain kinds of treatment by other individuals or by the government. There are many different kinds of rights. Natural or human rights are those rights that all persons have by virtue of their humanity. Constitutional rights refer to the rights that delineate government's responsibilities and protect citizens from violation of their rights. Legal rights are those that are granted by the specific legal system in which one lives, including the right to property. Civil rights refer to a specific subset of legal rights that uphold the dignity and independence of the individual in the legal and political arena. Economic rights refer to those relating to labor, to the acquisition and holding of property, and to the production, exchange, and consumption of goods and services. Sometimes rights may overlap with each other: for example, we have *natural* rights to "life, liberty, and property," but we also have *legal* rights to these things. Sometimes these rights come into conflict, as well.

In liberal democracies, everyone has some rights of each of these different kinds. Some of these rights are "negative," for example the right *not* to have government put us in jail without a good reason. Others are "positive" rights, like the economic right to have certain things, such as food, shelter, or medical care in case of unemployment or disability. The concept of "negative" and "positive" rights has its origin in the ideas of Isaiah Berlin who first published an essay on this topic in 1969¹. Although Berlin focused on the concept of "negative" and "positive" liberties and not rights, his reasoning can be extended to our application.

"In the first [or "negative"] case liberty seems to be a mere *absence* of something (i.e., obstacles, barriers, constraints or interference from others), whereas in the second [or "positive"] case it seems to require the *presence* of something (i.e., control, self-mastery, self-determination or self-realization)." According to Berlin's theory, "we use the negative concept of liberty in attempting to answer the question "What is the area within which the subject—a person or group of persons—is or should be left to do or be what he is able to do or be, without interference by other persons?" Whereas we use the positive concept in attempting to answer the question: "What, or who, is the source of control or interference that can determine someone to do, or be, this rather than that?"²

The United Nations Universal Declaration of Human Rights lists many positive rights. For example, Article 25 states:

Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and

necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

The United States *Bill of Rights* contains a number of negative rights that essentially define the extent of government's ability to interfere in lives of private citizens. In a sense, the *Bill of Rights* serves as protection of private citizens from excessive government control or even tyranny. For example, Amendment IV states:

The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no warrants shall issue, but upon probable cause, supported by oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

If one person has a right, positive or negative, the government, a business, or another person has the responsibility to protect or respect that right, whether that means doing something or not doing something.

Standards

Economic standard # 10:

Institutions evolve in market economies to help individuals and groups accomplish their goals. Banks, labor unions, corporations, legal systems, and not-for-profit organizations are examples of important institutions. A different kind of institution, clearly defined and enforced property rights, is essential to a market economy.

Economic Standard # 16:

There is an economic role for government in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

Grades 9-12 Civics Standard V B 1:

Personal rights. Students should be able to evaluate, take, and defend positions on issues regarding personal rights.

Grades 9-12 Civics Standard V B 2:

Political rights. Students should be able to evaluate, take, and defend positions on issues regarding political rights.

Grades 9-12 Civics Standard V B 3:

Economic rights. Students should be able to evaluate, take, and defend positions on issues regarding economic rights.

Grades 9-12 Civics Standard V B 4:

Relationships among personal, political, and economic rights. Students should be able to evaluate, take, and defend positions on the relationships among personal, political, and economic rights.

Grades 9-12 Civics Standard V B 5:

Scope and limits of rights. Students should be able to evaluate, take, and defend positions on issues regarding the proper scope and limits of rights.

Benchmarks

Students can use this knowledge to

- Distinguish among various kinds of rights.
- Explain how the nation-state plays a role in protecting rights.
- Explain how rights are related to political and economic freedom.
- Identify rights that are important in the political system, and rights important in the economic system.
- Explain why rights are essential to successful self-government and free markets.
- Explain why rights are seen as necessary to political and economic progress.
- Identify social forces that affect the protection or exercise of rights

Content Summary

Natural Rights

A liberal democracy like the United States is based on the idea of respect for the natural rights of its citizens. The Declaration of Independence explains that these natural rights—“life, liberty, and the pursuit of happiness”—are the basis of a *social contract*. The ideas in the Declaration are very similar to those of the English political philosopher John Locke. Locke argued that everyone has natural rights because they are human, but no one alone is powerful enough to secure his or her natural rights. In the social contract, people agree to form a society in which rights can be defended more easily.³ By defending their rights collectively, the people would be free to do other things, for example—earn a living. Locke also saw a connection between the people’s freedom to pursue a livelihood and economic growth in the society. The real art of government, Locke suggests, is not the art of war, but the “art of increase.”

Similarly, in the tradition of John Locke and the founding documents of the United States, government’s primary obligation is securing the rights, including the natural rights, of the populace. This means providing security against threats from both internal and external sources. In the former case, the government uses its *police powers* to “prevent the commission of fraud and crime, and secure generally the comfort, safety, morals, health, and prosperity of the citizens by preserving the public order, preventing a conflict of rights in the common intercourse of the citizens, and insuring to each an uninterrupted enjoyment of all the privileges conferred upon him or her by the general laws.”⁴ In the latter case, as seen in the *Rights and National Security* section below, government invests in a national military force, intelligence gathering, diplomacy, etc., to insure peace and prosperity of the nation and, subsequently, maximal fulfillment of its citizens’ rights.

Protecting the natural rights to life and liberty means, at a minimum, that a just government may not punish a person without a good reason. To assure that the reasons are good enough, there are *due process* rights. Moreover, what the Declaration of Independence calls the natural right to “the pursuit of happiness,” Locke called the right to property. People should not only have the right to accumulate as much income or wealth as they can, but government has a responsibility to protect the property that they acquire. By “property” Locke meant more than material goods. He included labor and creativity as well. The protection of property rights, then, is really a protection of the freedom to create new products and services—a protection of the *freedom* to create wealth as well as a protection of wealth itself.

The Declaration of Independence establishes securing individual rights as the *raison d'être* for government. The United States Constitution names securing “the Blessings of Liberty” as a primary reason for establishing the new union. This is explicit recognition that natural rights must be protected. One concern was clearly the possibility that, without government, anarchy would prevail. What would restrain the stronger from preying upon the weaker or organized gangs from seizing property and inflicting bodily harm on others? Clearly a central authority with power to protect members of society from each other was necessary.

All modern liberal democracies have established governments with police powers to, among other things, “preserve order.” The police force and criminal justice system are the most visible displays of police power. Citizens rely on the police and courts to secure their very persons and personal property,⁵ clear and well defined natural and legal rights of every complying citizen.⁶

The use of police powers necessarily results in the limitation of individual rights. Police have the authority to detain individuals, depriving them of freedom of movement. Courts can sentence individuals to prison. Most liberal democracies impose some restrictions on marches and protests to preserve public order and safeguard the rights of others, even though this limits freedom of speech and assembly.

Constitutional Rights

A government’s constitution specifies the structure and functions of a government. The United States Constitution also delineates binding constitutional rights that are designed to provide some specific limitations on government, and so to provide protection against violations of natural rights. So, for example, the Third Amendment prohibits the quartering of troops in private homes without the consent of the homeowner. This is a specific constitutional guarantee that supports the natural right to property. Other constitutional rights that are designed to protect natural rights include the right to *due process of law*, which in the 5th and 14th Amendments to the U.S. Constitution specifically refers to rights of “life, liberty and property.”

Other kinds of constitutional rights protect individuals’ rights to participate in the political and economic life of the society. Some countries’ constitutions include rights to education or employment, as we shall see. The U.S. Constitution does not make such guarantees. Instead, the U.S. Constitution limits the power of government as a way of encouraging the development of *civil society*.⁷ Civil society consists of all of the nongovernmental institutions—businesses, clubs, churches, and so forth—through which people pursue common goals. Alexis de Tocqueville,⁸ a French political philosopher who visited the U.S. in the 1830s, believed that a healthy civil society was important for the well being of democracy. Tocqueville believed that a *decentralized* system, which a flourishing civil society promoted, was important in helping prevent government from becoming tyrannical.

In the U.S., constitutional rights are found in the original Constitution of 1789, the Bill of Rights of 1791, and later amendments, particularly the Fourteenth Amendment (1868). The Bill of Rights is basically a set of negative rights restricting what the federal government may do to citizens. The Fourteenth Amendment has been interpreted by the U.S. Supreme Court to apply most of those negative rights as restricting the state governments as well.

In general, the exact content of constitutional rights has often been shaped by decisions of the Supreme Court. Because the U.S. Constitution is designed to remain the basic law as conditions change, it speaks in very general terms. It is up to courts to define, and when necessary to re-define, these terms in light of new developments in technology or society. For example, the Constitution guarantees freedom from unreasonable searches by the government.⁹ The

U.S. Supreme Court had to decide whether tapping telephones without a warrant constituted an unreasonable search of a person's property. Congress, however, also plays an important role in passing civil rights legislation, which also interprets the Constitution's terms, and in providing access to courts and other methods of asserting rights.

Rights' Protection and Implementation

In most countries, the first step in protecting rights is to write them down. Today, this usually takes the form of writing a constitution that includes a listing of basic rights. Some rights, however, are also protected by international agreements, such as the European Convention on Human Rights; countries that agree to the Convention are obliged to bring their own laws into compliance with its provisions. There is also a European Court of Human Rights to hear cases of countries accused of violating human rights.

Other rights are protected or granted by legislation. For example, the right to challenge false information in your credit report is a right that exists by law, but is not in the Constitution. So is the right to sue the manufacturer of a defective product that has injured someone. Rights within the legal system, such as the right to appeal a criminal conviction or a jury's award of damages in an injury case, are also protected by legislation.

It is important to remember that laws passed by Congress and other legislatures allow us to "have our day in court," and that even though we usually think of courts as protecting our rights, there is a very important foundation of statute law that provides access to the courts themselves. And while we think of the important rights of the Bill of Rights as providing the courts with the means to shield citizens against bad legislation, it is important to remember that such legislation does not actually get passed very often. Legislatures are required to interpret the Constitution, just as courts are, and most of the time unconstitutional proposals are thoughtfully debated and ultimately defeated by legislatures.

In many cases, government protects rights in more direct ways, through regulation and inspection of places, products, and working conditions. The Food and Drug Administration, for example, protects consumers' rights to uncontaminated foods and to drugs that do what they claim to do. The Occupational Safety and Health Administration protects people's right to a safe workplace. Notice that these are also examples of rights that have been decided upon through the political process and protected by legislation. These would not be recognized as "natural rights" by the authors of the Declaration of Independence, for example.

How Different Countries View Rights Differently

Most countries claim to protect the rights of their citizens. There are many differences, however, in assumptions about the sources of rights. In Great Britain, for example, there is no written constitution. Their constitution consists of traditions and attitudes as well as Acts of Parliament; but Parliament can change these laws at any time. Thus a "constitutional" right for a British citizen is different from a constitutional right of an American citizen, because it is much easier to modify or even abolish it.

Some countries, unlike the U.S., incorporate basic economic rights, such as the right to an education or the right to a job, into their legal system. The Chinese constitution protects the "right and duty" to work, as well as the right to rest, the right to a retirement income, and the right and duty to receive an education. Article 41 of the Irish Constitution provides that the government will try to make sure that "mothers shall not ... be obliged to engage in labour to the neglect of their duties at home." Both the Irish and Spanish Constitutions provide the right to a free primary education; the Spanish Constitution also "recognizes" "free enterprise

within the framework of a market economy.” Sometimes countries base their protection of rights on the previously mentioned Universal Declaration of Human Rights, which was drafted by the United Nations in 1948. Although many nations have ratified the International Covenant on Economic, Social and Cultural Rights, one of the treaties based on the Declaration, the United States is not one of them.¹⁰

Rights and Economic Security

All modern liberal democracies have adopted economic security as an explicit goal and a means to protecting their citizens’ economic rights, both “negative” and “positive.” The protection of “negative” economic rights puts a limit on government’s ability to regulate market processes and mechanisms, maximizing the individuals’ decision-making potential. Insuring equity in the individuals’ ability to participate in the market place or enforcing fair competition among actors are some examples of how “positive” economic rights are protected. While economic security has no precisely agreed upon meaning, societies at the very least attempt to provide income and other support services such as food, housing, and medical care to those who are in poverty or become unemployed, which is another example of how “positive” economic rights are protected. Countries have very different policies and levels of support to provide economic security. They have different rules for determining who is eligible for support, how much individuals will receive, how long benefits (such as unemployment compensation) will be provided, and which rights will dictate that.

These variations tend to reflect the different values and historical traditions in the respective countries. Programs tend to be smaller (at least on a per capita basis) and less comprehensive in the United States, given its traditions of individualism and federalism. Because of the latter, many specific provisions are matters controlled by individual states, so benefits vary widely. In contrast, many European democracies have policies that reflect their more collective orientation.

Liberal democracies often provide other programs that are presented as means to enhance economic security. In the United States, for example, the government maintains “disaster relief” programs that are primarily for victims of floods, tornadoes, hurricanes, and earthquakes. Among the benefits provided are low interest loans to rebuild businesses, homes, and farms.

Why Some Economic Rights Are Controversial

One of the reasons the U.S. has not accepted the Universal Declaration of Human Rights is that the Declaration protects economic rights. As noted above, one example is the right of each person to “a standard of living adequate for the health and well-being of himself and of his family...”. Many Americans believe that requiring government to protect such a right would require government to interfere with the workings of the marketplace. Such interference would introduce *inefficiencies* into the economy that would make American workers and American products less competitive.¹¹ It would also interfere with property rights, by making it necessary for government to tell employers how to use their property, that is, how to spend their money, essentially taking the decision-making power out of the hands of the individual consumer or firm; violating a fundamental tenet of free markets. Because the Constitution already requires the government to protect property rights, people argue that the U.S. could not accept the Universal Declaration without changing the Constitution. Moreover, some nations, including the U.S., believe that they are simply unable to provide the rights listed in Article 25.

Rights and National Security

Rights and other blessings of liberty also can be threatened by the actions of other nations. Invasion of a nation's territory is historically the greatest threat to its status quo and the rights that it guarantees. Nations devote considerable resources and effort to maintaining national security, and, subsequently, the rights of their citizens. Countries operate intelligence services to define the intentions and capabilities of potential adversaries; conduct diplomatic missions to negotiate peaceful resolution of disputes bilaterally or through international forums; enter into international agreements (as the aforementioned European Convention on Human Rights, for example), treaties, and alliances; and maintain defense forces such as an army, navy, and air force. Oftentimes, safeguarding the nation's security not only protects and furthers the rights of its citizens, but also the rights of people in other nations. For example, with the intention to maintain economic and political stability in the EU, important prerequisites to the entry of new members include improving human, economic, and political rights of their citizens.

Important contributors to national security are intelligence services. The intelligence services of the United States and Great Britain provided much of the information about weapons of mass destruction on which these countries based the decision to attack Iraq, for which they are currently receiving international criticism. The European Union, as part of its Common Foreign and Security Policy, has established The European Union Satellite Centre to enhance the EU's "capability to gather space related information to help prevent conflicts [and] support peace-keeping efforts..."¹² The North Atlantic Treaty Organization (NATO), was formed as a military alliance by the United States and European democracies to counter the perceived threat of the Soviet Union and its allies in the Warsaw Pact.¹³

NATO, other international organizations, and individual governments are attempting to respond to a new external threat—terrorism, an imminent threat to the natural rights of peaceful citizens all over the world. The events of September 11th, 2001 heightened the awareness of citizens throughout the liberal democracies of the danger posed by international terrorism. The next day NATO declared this to be an attack against all nineteen member-nations. This peril has resulted in many specific measures to increase security by nations throughout the world. Intelligence-gathering activities have been increased, new laws passed, individuals detained and questioned, and military operations conducted. Greater security against external threats has resulted in tradeoffs with other fundamental rights, a topic that is explored below.

Rights and Tradeoffs¹⁴

Rights are basic entitlements for everyone, but in practice rights have their limits. For example, the right to property is a natural right, but the U.S. Constitution allows government to take property "for public use" as long as there is "just compensation" for the owner. The government may take an individual's liberty as well, by putting him or her in prison, if that person has been convicted of a crime by "due process of law." Other limits on property rights have been accepted as well, such as zoning laws that restrict the uses to which property in a certain area may be put. For example, local governments in the United States can designate certain areas (or zones) of the community to be used exclusively for houses—no businesses can be built in these areas.

Even such seemingly absolute rights as freedom of religion and freedom of speech may be limited. Following the terrorist bombings in London on July 7th 2005, the British Parliament is (at this writing) considering legislation that would prohibit the preaching of religious extremism or incitement of violence. After a long period of political debate and social protests by civil rights and Muslim groups, the French government instituted a ban on wearing of the tra-

ditional feminine headscarf in public educational institutions. Some Native American religious practices involve the use of the drug peyote, but the Supreme Court has ruled that states may make that drug illegal. If you spread false rumors about someone, that person is entitled to sue you for slander or libel. Although you have a right to advertise products you wish to sell, you may not advertise illegal products. Even legal products, such as cigarettes, are subject to restrictions. The courts have held that these restrictions on free speech are necessary to serve other important goals of society.

The power of government to provide security carries with it the limitation of other fundamental rights. As noted above, for example, quarantines restrict the freedom of those exposed to a dangerous and infectious disease. The citizens of the newly formed United States were so acutely aware of the potential power of government that they insisted on the first ten Amendments to the new Constitution, the “Bill of Rights,” as a condition of support for ratification. The Bill of Rights limits governmental action by providing negative rights to the U.S. citizens. In the American tradition, the government is thought of both as a danger to freedom as well as a protector of rights.

As noted above, liberal democracies typically have constitutional limitations on the police powers of the government. In addition to establishing clearly defined individual rights, such as freedom of speech, there are constitutional provisions and laws that place limits on how the government can use its police powers. For example, the rights of accused persons are enumerated.

Nonetheless, the provision of security as a goal comes into conflict with other desirable goals. In the language of constitutions and laws there is room for interpretation, and hence, for societies (through their elected representatives) to lean toward a gain in some of one objective at the cost of giving up some of another objective; that is to make tradeoffs.

In the wake of attacks of attacks on World Trade Center in New York City and the Pentagon in Washington D.C. on September 11, 2001, new laws and increased anti-terrorist actions by authorities have sparked a continuation of the debate about trading rights for security. For example, the United States passed a new law called the Patriot Act. The new law:

[G]ives federal officials greater authority to track and intercept communications, both for law enforcement and foreign intelligence gathering purposes. It vests the Secretary of the Treasury with regulatory powers to combat corruption of U.S. financial institutions for foreign money laundering purposes...It creates new crimes, new penalties, and new procedural efficiencies for use against domestic and international terrorists.¹⁵

Criticism of the new law has come from many groups who believe this law and other official actions represent a bad tradeoff. “From the USA PATRIOT Act’s over-broad definition of domestic terrorism, to the FBI’s new powers of search and surveillance, to the indefinite detention of both citizens and non-citizens without formal charges, the principles of free speech, due process, and equal protection under the law have been seriously undermined.”¹⁶

Enduring Issues

- What rights should be protected by the state? Is the best way of protecting political and economic freedom to limit the power of the state?
- Are economic rights of equal importance with rights that relate to the political and legal systems?

- Should people in wealthy societies have rights to health care? To an education? To a minimum level of income?

Public Policy Question

Both Locke and the framers of the U.S. Constitution believed that by protecting property rights people will be encouraged to create and bring new products to market. This is why the Constitution allows Congress to “promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.” These are patents and copyrights. But how long should that “exclusive right” last? Currently, the law is that copyrights extend for the life of the author plus 75 years. After that, things belong to the “public domain,” that is, to everyone.

Some believe that these exclusive rights should be secured for a longer time. But is this fair to society? Should the “exclusive right” to the profits of one’s invention or writing be extended to the grandchildren of the original authors or composers? Is longer patent or copyright protection really likely to encourage new inventions and works of art?

Economics Lessons

Lesson 2: Property Rights and Contracts as Economic Institutions

Focus: Institutions and Markets

Students consider the importance of a system of defining, recording and protecting property rights in a market-based economy. Students differentiate between private and communal property, they consider various methods for recording property ownership, and they examine one institution? The United States Patent and Trademark Office? created to define and protect property rights. Finally, students examine a timely case involving questions of property rights—Napster vs. Metallica.

Grade(s): 9-12

Lesson 4: Sparta, Athens, Cuba and the United States; Ancient and Modern Examples of Command and Market Economies

Focus: Economic Systems

Students compare the economies of ancient Sparta and Athens using primary sources of speeches and other historical accounts. Students then compare the current economic systems of the United States and Cuba, using passages from their respective national constitutions.

Grade(s): 9-12

Lesson 19: Privatization Around the World

Focus: International Economics

In this lesson, students review and evaluate the approaches most widely used to privatize public enterprises and services. They also review some international comparisons on the success of these programs in different nations. In the assessment section, references to several articles on privatization that have appeared in recent issues of *The Economist* magazine are provided to enable teachers and students to learn more about specific examples of privatization programs in many different countries and industries.

Grade(s): 9-12

Lesson 4: How to Privatize?

Focus: From Plan to Market: Teaching Ideas for Social Studies, Economics, and Business

Classes

By reference to property rights, students discuss the solution to the problem of the mess in the school cafeteria. They work in cooperative groups to identify advantages and disadvantages of alternative approaches to privatization. In class discussion, they analyze the strengths and weaknesses of all four approaches to privatization.

Grade(s): 9-12

Unit 1: Lesson 1 - How Has the Constitution Shaped the Economic System in the United States?

Civics and Government: Focus on Economics

Students provide their own examples of the six characteristics of a market economy as they exist in the United States today. Then they see how the U.S. Constitution supports those characteristics by reading relevant portions of the Constitution, and matching these provisions with the six characteristics of a market economy. The lesson concludes by having the students read and discuss relevant portions of the Constitution of the People's Republic of China.

Grade(s): 9-12

Institutions

Nexus Statement

Institutions are arrangements and settled practices that have evolved or been established to perform political and economic functions for the benefit of the whole society or groups within it.

Rationale Statement

Institutions are essential to modern political, economic, and social life interactions. Institutions have been defined broadly as established laws, customs, practices, organizations, regulative principles, or conventions that serve the needs of an organized community.¹⁷ They also have been defined as patterns of expected action, enforced by social sanctions, both positive and negative.¹⁸

Institutions are important, because, while we in concert with others create institutions, they also “create” us or shape our lives in significant ways. Much of our lives are lived in and through institutions. It is important, therefore, that we understand what institutions are, how and why we form them, and how they, in turn, affect our lives.

For example, the National Council on Economic Education has stated that “institutions play a number of roles in a market economy. Property rights help insure that people bear the costs and reap the benefits of their decisions. Property rights and contract enforcement encourage investment by assuring investors that they will reap the rewards of deferring consumption and assuming risk if these investments perform well. Limiting individual liability and allowing people to pool their investment resources through joint stock corporations also increases investment and future income.”¹⁹

Standards

Economic Standard 10:

Institutions evolve in market economies to help individuals and groups accomplish their goals. Banks, labor unions, corporations, legal systems, and not-for-profit organizations are examples of important institutions. A different kind of institution, clearly defined and enforced property rights, is essential to a market economy.

Civics and Government Standard 9-12, III.B.1:

Students should be able to evaluate, take, and defend positions on issues regarding the purposes, organization, and function of the institutions of national government.

Civics and Government Standard 9-12: III.B.2:

Students should be able to evaluate, take, and defend positions in issues regarding the major responsibilities of the national government for domestic and foreign policy.

Benchmarks

Citizens can use this knowledge to:

- Listen to a presentation on the role banks play in channeling funds from savers to borrowers and investors and draw a diagram showing the role that financial intermediaries play among savers, borrowers, and investors.
- Predict what might happen if there were no legal way to settle boundary disputes or if every state had its own system of weights and measures or currency; explain how strict liability for product defects affects the behavior of consumers and producers and how it affects the price of a good or service.

- Read about the establishment of the AFL-CIO; explain why it emerged and what procedures it used to gain benefits for its members.
- describe purposes, organization, and functions of the three branches of government
 - **legislative**, i.e., the Congress, composed of a House of Representatives and a Senate, including their committees and their respective staffs and most prominent auxiliary agencies, e.g., the Congressional Budget Office, Library of Congress
 - **executive**, including its most prominent agencies, e.g., State, Defense, Health and Human Services, Justice, Education
 - **judicial**, including the Supreme Court of the United States and the federal court system
 - **independent regulatory agencies**, e.g., Federal Reserve Board, Food and Drug Administration, Federal Communications Commission.
- evaluate competing arguments about the proper role of government in major areas of domestic and foreign policy, e.g., health care, education, child care, regulation of business and industry, foreign aid, intervention abroad.

Content Summary

All societies are organized around institutions that, among other things, facilitate the distribution of power and of scarce resources within the society. Four major forms of institutions exist²⁰:

1. **Formal structures or organizations as institutions**—religious and charitable organizations; schools and universities; military services; corporations; banks; branches of government, including for example, legislatures, executive cabinets, and court systems
2. **Regular processes as institutions**—rule by majority decision, as in most legislative votes and general elections, trial by jury
3. **Established relationships as institutions**—marriage, friendship, doctor-patient, lawyer-client, enduring political alliances, including international alliances, and coalitions
4. **Recognized patterns of behavior as institutions**—relying on the advice of cabinet ministers, relinquishing office after losing an election

All institutions share similar characteristics, regardless of type or variety. First, institutions tend to exist for long periods of time and to work in accord with established procedures. This durability and order may facilitate reliability and predictability. It also may result in dysfunctional stagnation and rigidity. Second, unlike persons, institutions have an indefinite life span. Although their members may come and go, institutions may last for long periods of time and link generations. Thus, institutions may give society a sense of permanence and durability. They also may result in obsolescence and stultification, or they may lose sight of their original purposes. Third, over the course of time, institutions develop their own internal “institutional memory” through traditions, histories, records, and the long service of individuals. This institutional memory provides a means for the transmission of acquired knowledge, expertise, and wisdom. Institutions also may be dominated by the past and resist change. Fourth, established institutions, by their very nature, may provide a beneficial check on aggregations of power that may be arbitrary and dangerous, e.g., courts of law versus mob rule. They also

may result in stalemate and gridlock. Finally, institutions may compete with one another and thus promote a balance of power that facilitates diversity and liberty, countering domination by any single power or combination of interests. They also may aggrandize themselves, overpowering individuals and other organizations perpetuating themselves beyond their utility.²¹

Economic Institutions

George Horwich described institutions as “any formal or informal set of rule, beliefs, or behaviors that play a role in carrying out organized activity. Markets, which are mechanisms for coordinating and carrying out production, distribution, and consumption of goods and services using scarce resources, are themselves institutions.”²²

Most people are familiar with the major governmental institutions: the legislative (i.e., Congress, Parliament), the executive (i.e., President, Governor, Prime Minister), the judiciary (i.e., courts), and the bureaucracy. They are less familiar, however, with institutions that establish and maintain a legal framework for economic activity, including the specification and enforcement of private property rights.²³ Such property rights are at the heart of market-based systems. Indeed, many economists argue that the first necessary institution in a market economy is a clear system of defining, recording, and enforcing private property rights.²⁴ Why are private property rights so integral to a market system? Without some guarantee that property rights are exclusive (belong to the owner alone) and transferable (owners can decide how to use or sell their property), people will have little incentive to accumulate property and grow economically. What business, for example, would take the risk of producing a new product if their new product design could be immediately taken away by a rival firm? In the absence of private property rights, the exchange of goods and services at all levels will be sharply curtailed. Consider what might happen if businesses (or individuals) were each forced to allocate their own scarce resources to protect their private property from such arbitrary taking (e.g., hiring a private police force). Such resources could not then be used in other, perhaps more productive, ways. This ‘trade-off’ would carry a high opportunity cost and this implies that governments should act to define, record, and enforce property rights, and be responsible for providing institutions for doing so.

Another reason for developing institutions to define and enforce private property rights has to do with stewardship of scarce resources. When individuals own property, they are likely to use that property more wisely than property owned in common with others or owned by the government. There are several reasons for this. First, private property owners benefit directly from wise use of their property, and they alone suffer the costs if they fail to maintain their property or use it wisely. Second, it is in the private owner’s best interest to put his or her property to its most productive use; the more productive the use, the more the owner benefits. Finally, private ownership can promote the common good because when property owners use their property in ways that others find useful, the value of the property increases. When property is not privately held, but held communally by government or a large group of people, there are fewer incentives to manage that property wisely. This is because the costs and benefits of ownership are not felt directly by each user. For example, which is more likely to be well-treated, cleaned, and maintained: the bus you ride to work on, or the car you just purchased with your own hard-earned money?

Thus markets require institutions to protect citizens’ rights to own and use private property. Indeed, the idea of protecting property rights was so important to the drafters of the United States Constitution that they gave clear powers to Congress to define and enforce them. One of these institutions is the United States Trademark and Patent Office.

Institutions that Define Property Rights: The United States Trademark and Patent Office

“To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries...” (Article 1, Section 8; US Constitution)

Some institutions evolve slowly over long periods of time; others are mandated and created quickly. The latter was the case with the United States Trademark and Patent Office (USTPO) that was created following the adoption of the United States Constitution in 1787. The founders knew that providing an institution that both provided a mechanism for safeguarding and recording ownership of the nascent nation’s intellectual property was essential to economic success in the new United States.

The USTPO promotes industrial and technological progress in the United States and strengthens the national economy by administering the laws relating to patents and trademarks and by advising the Secretary of Commerce, the President of the United States, and the Administration on patent, trademark, and copyright protection and trade-related aspects of intellectual property.²⁵

Recording and Defining Intellectual Property Rights²⁶ Patents, Trademarks, and Copyrights

The USPTO defines a **patent** for an invention as “the grant of a property right to the inventor.”²⁷ Essentially, such a patent guarantees the inventor sole ownership of his or her unique product or idea for 20 years from the date on which the application for the patent was filed in the United States. This patent gives the owner the right to decide whether to sell (or withhold) all or some of his or her product in the marketplace. By law, those who wish to use the patent owner’s ideas or product must gain permission (often through payment of a fee) from the owner to do so.

According to the USPTO, “the right conferred by the patent grant is...the right to exclude others from making, using, offering for sale, or selling the invention in the United States or importing the invention into the United States.”²⁸ What is granted to the owner, then, is not the right to make or sell the idea or product, but the right to exclude others from making or selling it. The USPTO confers three types of patents:

1. “Utility patents may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or compositions of matters, or any new useful improvement thereof;
2. Design patents may be granted to anyone who invents a new, original, and ornamental design for an article of manufacture; and
3. Plant patents may be granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plants.”²⁹

Trademarks

The USPTO defines a **trademark** as a word, name, symbol or some other such device which is used to indicate the source of the goods and to distinguish them from other similar goods. Such a trademark simply communicates to the potential consumer the source of the product. A **servicemark** identifies and distinguishes the source of a service rather than a good. Unlike patents, trademark and servicemark rights do not prevent others from making the same

(or similar) goods or services, but rather prevent others from using a similar mark that might mislead the consumer about the source of the good or service.

A *copyright* is a type of right provided to the authors of original works of intellectual property such as music, literature, and artwork. Copyrights may be granted to both published and unpublished works. The 1976 Copyright Act generally gives the owner of copyright the exclusive right to reproduce the copyrighted work. That is, only the author, artist or musician can legally re-print or perform the work. According to the USPTO, the copyright protects only the form of expression and not the subject matter of the writing.³⁰ For example, a description of a machine could be copyrighted, but this would not prevent others from writing a description of their own or from making and using the machine. Copyrights are registered by the Copyright Office of the Library of Congress.

Why are patents and copyrights so important? The framers of the US Constitution recognized that, if the new nation were to thrive, it was essential to provide a system that provided incentives to innovate and to invent. Such incentive structures are built around personal gain associated with successful and beneficial inventions and innovations. One might argue that Thomas Edison, for example, invented new products for the sheer pleasure of discovery (and this might well be true), but as soon as Edison's invention of the light was perfected, he launched the Edison Electric Light Company—a corporation bent on making profits. Edison would not have benefited as greatly—perhaps not at all—from his invention of the light bulb had he not owned the property rights, in the form of his patent, to it.

Finally, given today's increasingly interdependent world, the question of defining intellectual property rights is also one that has global ramifications. Indeed, recent reports suggest that the theft of intellectual property rights (e.g., copying and selling copyrighted materials on CD) is on the rise.³¹ While no international patent office comparable to the USPTO exists, sections of the World Trade Organization's (WTO) Agreement On Trade-Related Aspects of Intellectual Property Rights (TRIPS)³² require the 144 member nations of the WTO to recognize patent and trademark rights. Because dozens of nations are not WTO members, problems can arise when some non-member countries do not recognize nor actively enforce those rights. Problems also arise when some WTO member countries (e.g., countries of the former Soviet Union and other transition economies) fail to meet the intellectual property rights statutes of the TRIPS agreement.

Enduring Issues

- Why do all societies require institutions?
- Why are well-defined and enforced property rights essential to a market-based economy?
- How is 'intellectual property' similar to, and different from, other forms of property?
- Should a single international institution (e.g., the WTO) be charged with defining and enforcing intellectual property rights? What are the tradeoffs in such a policy for developed countries such as the United States?

Public Policy Question

In 1999, an 18-year old developed software that allowed computer users to create and trade MP3 files (a digital music format) that contained popular music. This software was made available (at no price cost) via a website called "Napster." Millions of people around the world began to copy and share their favorite music in the MP3 format. However, many of the MP3

files had been illegally reproduced without compensating the artists who created the music and now held the copyrights to it. Many artists felt that they were becoming victims of computer piracy. In spite of the computer users (and Napster's) claims to be only harmlessly sharing computer files with friends, musicians felt their privately owned and copyrighted work was being stolen and in a way not so different from shoplifting a CD from a local music store. Was this simply a case of outright theft? Was Napster encouraging violations of copyright law? How was the nature of the MP3 files (as compared to CDs) allowing this to occur? In 2000, the heavy metal band Metallica brought this issue into public light by suing Napster for copyright violation. A large proportion of the MP3 files Napster users were copying and sharing were Metallica songs.

- Why were artists such as Metallica so outraged at Napster?
- Do copyrights truly act as incentives for artists?
- What impact does the music format have on these questions?
 - Can Metallica own its music in both formats?
 - Does Metallica have exclusive control over its music in both formats?
 - Can Metallica exchange the property right (i.e., sell it or give it away) to their music in this format?
- What role should the government take in this debate?
- Can you think of other examples where property rights questions have evolved as technology has changed?
- How are property rights defined when the rights transcend national borders. That is, how can property rights be enforced when products are sold in multiple nations?

Economics Lessons

Lesson 1—Markets and the Market System

Focus: Institutions and Markets

This lesson introduces students to the primary economic institution in a market economy, markets. The first activity in this lesson stresses the decentralized nature of decision-making in competitive markets, and shows how self-interested behavior by individuals in these markets regularly leads to efficient outcomes. Next, the links between different types of markets are explored through a circular flow activity. Finally, the importance of prices that are free to rise or fall to achieve market equilibrium is demonstrated.

Grade(s): 9-12

Lesson 2: Property Rights and Contracts as Economic Institutions

Focus: Institutions and Markets

Students consider the importance of a system of defining, recording and protecting property rights in a market-based economy. Students differentiate between private and communal property, they consider various methods for recording property ownership, and they examine one institution—the United States Patent and Trademark Office—created to define and protect property rights. Finally, students examine a timely case involving questions of property rights—Napster vs. Metallica.

Grade(s): 9-12

Lesson 3: Business Organizations

Focus: Institutions and Markets

Students first look at a list of business names and discuss what the various abbreviations that are often used as part of businesses' names mean. In a reading, students learn about three types of business organizations—sole proprietorships, partnerships, and corporations. They compare the advantages and disadvantages of each type of business organization, including problems that arise when the objectives of a firm's owners' (principals) differ from the objectives of the firm's managers (agents) and other employees.

Grade(s): 9-12

Lesson 4: Financial Systems

Focus: Institutions and Markets

Students participate in a brief simulation to demonstrate the important role financial intermediaries play in promoting investment and economic growth in market economies. Through direct instruction, students learn some specialized terms related to financial markets. Then students participate in an activity to help them identify other financial institutions in a market economy.

Grade(s): 9-12

Efficiency

Nexus Statement

One goal in both a market economy and a democratic society is efficiency. While there are numerous definitions of efficiency, one way to conceive of efficiency is this: for both the economy and political system generally to produce outcomes most desired by citizens.

Rationale Statement

Efficiency is a difficult idea, often subject to different popular and technical conceptualizations, in the operation of both economies and governments. Nonetheless, it seems reasonable that market economies and democratic governments share the notion that the operation of both the economy and political system should, in general, produce the best outcomes; that is, for the government to make the laws and policies that citizens most desire and for the economy to maximize the production of the goods and services that consumers want most.

Naturally, not everything a consumer wants is valued by others. An evening of gambling at the casino might be one person's idea of entertainment, but another may view it as an incredible waste of resources. Because we have no universally accepted way of setting priorities for the value of untold numbers of goods and services, market systems let individual choices through markets determine how much of what goods and services to provide. Competition in markets generally works to ensure that those goods and services are produced in the most efficient way, thereby increasing the total output of goods and services. A similar notion of efficiency might be adopted in considering the activities of democratic governments; that is, efficiency could be defined in terms of how well the will of the people is translated into laws and public policy. In both, there is a need to pay attention to inherent flaws that limit the attainment of efficiency and the real existence of tradeoffs between efficiency and other goals such as equity or security.

Standards

Economics Standard 9:

Competition among sellers lowers costs and prices, and encourages producers to produce more of what consumers are willing and able to buy. Competition among buyers increases prices and allocates goods and services to those people who are willing and able to pay the most for them.

Economics Standard 17:

Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

Civics and Government Standard 9-12: I.A.1:

Students should be able to...describe government as the formal institutions with the authority to make and implement binding decisions about such matters as the distribution of resources, the allocation of benefits and burdens, and the management of conflicts.

Civics and Government Standard 9-12: I.A.2:

Students should be able to explain several major arguments for the necessity of politics and government, e.g., because human beings ... working collectively can accomplish goals and solve problems they could not achieve alone.

Benchmarks

- Citizens can use this knowledge to:
 - Define and explain the importance of economic efficiency.
 - Explain efficiency in terms of scarcity and resources.
 - Define and explain the importance of efficiency in a democratic government.
 - Trace the historical development of changes instituted to make democracy more efficient.
 - Identify tradeoffs in desirable goals to gain (or give up) increments of efficiency.
 - Evaluate potential public policies in terms of their probable impact on efficiency.

Content Summary

Efficiency in the Economy

In economics, scarcity is assumed: that is resources are insufficient to meet all of the ways in which humans wish to use those resources. By resources, economists mean “the instruments provided by nature or by people that are used to create goods and services humans want.”³³ Typically, these resources are referred to as land, labor, capital, and entrepreneurship. “Land” means not only arable soil used in farming for example, but all natural resources, such as minerals, air, and water. The work that people can do, whether physical or mental, is encompassed by “labor.” By “capital,” economists mean those things (such as factories and machines) that are produced in order to produce other things. “Entrepreneurship” means organizing and assuming risk in pursuit of profits.³⁴

The primary job of an economic system is to allocate these scarce resources among alternative, and therefore competing, ends. There is an opportunity cost to the use of any resource. Resources used to produce one thing cannot be used to produce something else. A society must have a mechanism to decide how much of which things to produce, how to produce those things, and who should receive what portions of that which has been produced.

Liberal democracies with market economies use markets as the primary means to determine the allocation of resources. A significant virtue of a market system is that, when markets are operating competitively³⁵, it promotes economic efficiency. Alan Blinder has noted that “...economists’ definition of efficiency (roughly the absence of waste) differs from common usage...”³⁶ For our purposes here, we will follow Blinder’s lead and avoid the more technical discussion of efficiency. It is enough to think of economic efficiency as “the absence of waste.”

Competition forces producers to find the least costly way to produce goods and services. Prices in market systems are a measure of relative scarcity. When the price of a resource rises (for instance, labor) relative to other prices, this is both a built-in signal and an incentive for the producer to shift to the use of other, relatively lower priced resources (perhaps using more machinery) in the production process. This is consistent with our idea of economic efficiency. That is, avoiding waste by maximizing the production of what people most want. This is because using resources efficiently results in more goods and services being produced, something that most (but not all) people clearly want. Similarly, consumers respond to prices as measures of relative scarcity. Faced with a rising price for beef, consumers buy less beef and more of substitute goods, such as chicken or pork.

Moreover, producers, always seeking profits, have an incentive to make goods and services that people want. Those who do find a market. Producers of goods and services that people shun are forced to make something else or go out of business, thus causing resources to be redeployed to other, more valued uses.

In contrast, command economies (where the authorities make the decisions about how to use productive resources) are known for economic inefficiency. Without competition, organizations do not have the incentive to find less costly methods of production. In fact, because prices on everything from resources to finished goods are set by the planners, there is no way to tell when the mix of resources should be changed in the production process—there is no clear signal of relative scarcity. And command economies frequently produce goods and services that consumers do not want, once again primarily due to the absence of effective prices and incentives.

Among the important caveats in this chain of reasoning, however, is that an efficient market system will direct resources to goods or services for which some people are willing and able to pay, but that others feel are silly, perhaps even harmful. That wealthy people have a commensurately greater ability to pay than others might result in “conspicuous consumption” (yachts, lavish parties, etc.) that others would find wasteful, especially when there are homeless to be housed. Nonetheless, such outcomes are economically efficient and consistent with other values, such as economic freedom which dictates that individuals get to decide what to do with their own income and resources.

This raises another caveat. In market economies, the individual is assumed to be the proper focus of decisions and rights. Consider the conception of efficiency at the beginning of this section—producing the outcomes that people want. In a market economy, the outcomes are assumed to be those goods and services favored by each individual in commanding her or his resources. But, as the examples above illustrate, some outcomes are not what *everyone* wants. Thus, the United States and other Western democracies have chosen to use collective decisions through government to change the economic allocation of resources in a variety of ways in order to meet other desirable goals, for example through income redistribution programs to assist the poor. The same societies often regulate, tax, or even prohibit activities and consumption that are seen as less desirable (e.g. gambling, alcohol, and illicit drugs, respectively). Thus, efficiency in the economy sometimes yields to other important social goals.

Moreover, as is described in the “Failures” nexus point in this document, markets will not produce “public goods”—goods and services such as national defense. Public goods are desirable and needed, but a market system will not allocate sufficient scarce resources to their production. So, while a market system promotes economic efficiency (relative to other systems for allocating scarce resources), there are clearly reasons for the people through their government to make some decisions, and in some cases override the decisions of the marketplace.

Efficiency in Government

As the foregoing illustrates, people often do not agree on what should be produced in the economy; nor do they agree on the actions of government. Still, if an efficient government is one that produces the outcomes that citizens want, liberal democracies would lay claim to meeting this goal better than other possible arrangements. In America’s constitutional democracy, the fundamental idea of popular sovereignty means that “The citizenry...holds ultimate authority over public officials and their policies. Within constitutional limits majorities should have the right to make political decisions.”³⁷ For example, such constitutional limits include the protection of free speech, even for those holding unpopular views.

In theory, democracy is clearly an improvement over those historical alternatives where an expression of the will of the people was either absent or ignored. Monarchs might have heard some dissent, but were free to act as they chose since they ruled by divine right. Modern authoritarians and dictators routinely disregard what citizens in their state want or need. So, liberal democracies begin with the advantage in efficiency of having both mechanisms for the will of the people to be expressed and for the removal of officials who fail to heed that will.

But, even in a constitutional democracy the efficiency of government in turning majority will into policy is limited—intentionally so, at least in part.³⁸ As noted above, there are constitutional restraints on the power of the government. This is intended to preserve the fundamental rights of individuals even in the face of overwhelming majority pressure—to prevent the so-called “tyranny of the majority.”

The adoption of a constitutional democracy does not, in itself, assure society of an efficient government (within the limits of the constitution). How democracy is implemented can be very important. The history of the United States is replete with reforms intended to make democracy work “better,” that is to make government policy more reflective of the will of the people—or, in the terms we have been using here, more efficient.

One category of such reforms is voting reform. A host of changes have been made in the name of reform. Poll taxes and literacy tests were eliminated in an effort to make sure that the expressed preferences of citizens were not limited by economic status and ethnicity. Limits on campaigning near polls were established to lessen voter intimidation. Even the design of the ballots is important—witness the events of the presidential election of 2000, especially in Florida where the outcome of the race hung in the balance. Some individuals were confused by the format of the ballots and did not vote for the candidate they preferred. Some ballots had “hanging chads”³⁹ and were not properly counted by voting machines. So, new national legislation mandates the use of other electronic devices to replace older technology to reduce voter confusion and improperly cast or counted ballots. Voting reform is an ongoing process, but one intended to ensure, as much as possible, that voting accurately reflects the outcomes that people want.

Another category of reform is the scope of decisions that is within the direct grasp of the people. Clearly, in representative democracy, the basic design is for people to elect others (representatives) who make the laws and policy decisions. Popular control is exercised by the ultimate authority to vote the current representatives out in favor of others. Representative democracy made especially good sense in times when travel was slow and communication difficult. Moreover, when issues are complicated, the accumulated expertise of a long-serving representative might be helpful. Nonetheless, some issues have been brought within more direct control of the populace by such mechanisms as the referendum and initiative, which are good examples of democratic implementation, intended to make government more responsive to the will of the people.

However, it should be noted that referendum, initiative, and other tools of direct democracy are not without problems. Sometimes special interest groups have run well-financed campaigns to succeed at the ballot box where they could not with the legislature. Critics of these tools have also pointed out that legislators can avoid their responsibilities to make difficult decisions by placing some issues on the ballot for a direct vote.

It is one thing to identify what people say they want their government to do; it is another to turn these preferences into reality. In recent years, governments at all levels have attempted other reforms to use resources allocated to government more efficiently. For example, given the choice of providing a service with government employees or through private companies,

governments are increasingly turning to the private sector. This is the case in services as diverse as data management, providing electrical power, collecting trash, and running prisons.

Of course, in some other senses of efficiency, democracies fare less well. The dictator likely has a very rapid process for assessing the will of the relevant decision-maker (himself!). For democratic decision-makers, the public will might be divided among a number of positions, all held with varying degrees of fervency. Policy is likely to emerge slowly in a process of a series of compromises. Democracies give up something in the efficiency of acting quickly in order to weigh and balance competing views. Moreover, when voters select a representative, they get a “package deal”—all of the perspectives, values, and policy preferences of the representative, many of which even a citizen who voted for that candidate might not like.⁴⁰

Liberal democracies with market systems, by virtue of the basic nature of their governments and economic systems, have structures that go a long way toward delivering a basic expectation of the citizens—that their government and economy should operate efficiently, at least if one considers efficiency as it has been defined here: giving the people what they want.

Enduring Issues

- By other definitions of efficiency, democracy and market systems might be inefficient. For example, the democratic process can be slow and cumbersome in reaching decisions, and often policies are compromises necessary to achieve majority support. Might it be that other forms of government and economic systems are better for some societies?
- The economic conception of efficiency is based on the individual determining what is valuable. Should such judgments be made collectively?
- Some people make bad decisions—they choose things they shouldn’t. How much protection from such choices should society adopt?
- People also sometimes make poor choices about candidates and issues. Is it really desirable to have a system that attempts to give the people what they want?

Public Policy Question

Should citizens be required to vote? An assumption of liberal democracies is that citizens will participate in the political process. The most observable behavior of participation is voting. If large numbers of citizens fail to vote, the persons elected as the people’s representatives might not hold the values nor advocate the policies that the majority of citizens really want. Voter participation varies widely around the world. The survey of participation rates by International Institute for Democracy and Electoral Assistance shows a range from Italy’s 92.5% to Mali’s 21.7%.⁴¹

There has been extensive research into voter participation (turnout). Economists have argued that not voting is rational since the marginal costs of voting (studying the candidates positions, going to the polls) outweigh the benefits (the likelihood that one voters’ ballot will make a difference is very small). Other economists have noted that the “intrinsic benefits” of voting (for example, satisfying one’s sense of civic duty) obviously must tip the scales in favor of voting, at least for some citizens.

One must also consider the whether a society views voting as a right (or privilege) or a civic duty. Some liberal democracies view voting as the latter—and enforce that view with sanctions. Australia, for example, levies fines against citizens who cannot satisfactorily explain why they did not vote. Turnout in Australia averages 84.4%.⁴²

Is voting a right, to be exercised at the discretion of the citizen, or a duty, to be required by the state?

Economics Lessons

Lesson 1: Broad Social Goals of Economic Systems

Focus: Economic Systems

Students create their own utopian society by rating five broad social goals. They learn about characteristics of command economies and market economies and make judgments about the goals that are most valued in each type of system. Finally, using data that measure various kinds of national economic performance, they evaluate the economic systems of different countries using the five social goals.

Grade(s): 9-12

Microeconomics Unit 5: Lesson 4—Efficiency, Equity and the Effects of Government Policies

Advanced Placement Economics: Teacher Resource Manual

Previous lessons have examined the role or size of government. This unit looks at the distribution of income and the effects of government policies to change it. The controversy weighs efficiency against equity.

Grade(s): 9-12

Lesson 1—Markets and the Market System

Focus: Institutions and Markets

This lesson introduces students to the primary economic institution in a market economy, markets. The first activity in this lesson stresses the decentralized nature of decision-making in competitive markets, and shows how self-interested behavior by individuals in these markets regularly leads to efficient outcomes. Next, the links between different types of markets are explored through a circular flow activity. Finally, the importance of prices that are free to rise or fall to achieve market equilibrium is demonstrated.

Grade(s): 9-12

Unit 1: Lesson 3—What are the Costs and Benefits of Voting?

Civics and Government Focus: Economics

Students examine voter participation rates in the United States since 1952. Cost/benefit analysis is introduced to help explain voter participation rates. Students identify ways to reduce the costs of voting and increase the overall voter participation rates.

Grade(s): 9-12

Decision Making

Nexus Statement

Economic resources used to produce goods and services are scarce, forcing individuals and governments to make choices about how to use those resources. All choices have costs, and analyzing costs incurred relative to benefits received is an important aspect of decision making in both the marketplace and in the voting booth. Often, both individual and government decision-making involve trade-offs—giving up some of one thing in order to get a little more of something else.

Rationale Statement

Human desire for goods and services always exceed society's ability to provide them. Because productive resources are scarce, choices must be made about how they will be used. Identifying and systematically comparing alternatives enables people to make more informed decisions and to perhaps avoid unforeseen consequences of choices they or others make.

Some citizens hold the mistaken view that they can have all the goods and services they want from the government because goods provided by governments are free. Resources always have alternative uses, even if governments own them. For example, if a city uses land to build a football stadium, the next best alternative use of that land must be given up. Economists refer to this as the opportunity cost—the value of the next best alternative (the one we give up when we make a choice). For example: if additional funds are budgeted for police patrols, the trade-off is less money is available to hire teachers; the opportunity cost is the value of the education given up when fewer teachers were hired. By comparing the benefits and costs associated with choosing one alternative with those associated with choosing another, citizens and their political representatives can systematically weigh choices in order to make better decisions. This analysis can highlight the consequences of their actions for themselves and others, and can lead to a heightened sense of responsibility and accountability.

Standards

Economics Standard #1:

Productive resources are limited. Therefore, people cannot have all the goods and services they want; as a result, they must choose some things and give up others.

Economics Standard #2:

Effective decision making requires comparing the additional costs of alternatives with the additional benefits. Most choices involve doing a little more or a little less of something; few choices are all-or-nothing decisions.

Grades 9-12 Civics Standard I. A.1.:

Students should be able to ... describe **government** as the formal institutions with the authority to make and implement binding decisions about such matters as the distribution of resources, the allocation of benefits and burdens, and the management of conflict.

Grades 9-12 Civics Standard I. A.2.:

Students should be able to ... explain why politics is found wherever people gather together, i.e., it is a process by which a group of people reach collective decisions generally regarded as binding on the group and enforced as common policy.”

Benchmarks

Citizens can use this knowledge to:

- Describe historical and contemporary issues which involve conflicts among fundamental values and principles and explain how these conflicts might be resolved:
 - Liberty and equality
 - Liberty and authority
 - Individual rights and the common good
- Explain why people may agree on values or principles in the abstract, but disagree when they are applied to specific issues, e.g., the right to life and capital punishment
- Identify what they gain and what they give up when they make choices.
- Apply the concepts of marginal benefit and marginal cost to an environmental policy to find the optimal amount of pollution for two firms that have substantially different costs of reducing pollution.
- Use the concepts of marginal cost and marginal benefit to evaluate proposals for a pollution control ordinance aimed at maximizing economic efficiency; then select the best proposal, and explain why it seems best.

Content Summary

Like individuals, governments and societies must choose from among competing alternative uses of scarce resources. Because human wants exceed what can be made from these scarce resources, individuals and governments must forego the benefit of alternative use of these resources. Markets and systems of self-government both require decisions from individuals. Making decisions that provide the greatest possible return from available resources requires that people, acting either individually or collectively, weigh all the benefits against all the costs of using their resources. Rarely are such decisions ‘all or nothing.’ Rather individuals and governments are often faced with choices that may require a little more of some things and a little less of others. For example, a family must decide if the benefits of spending additional amounts of their income on their children’s education is greater than the costs they will incur by giving up other uses of that income, such as purchasing a new family car. The managers of an automobile company must decide how many fewer sedans to produce in order to increase their output of sport utility vehicles. School officials must weigh additional spending on textbooks versus buying new equipment for their athletic teams. Government officials must decide whether to increase public spending programs or whether the resulting increase in taxes is worth the foregone private consumption or investment.

Economic and political decision making, particularly in budgeting, requires a focus on changes in benefits and comparing them to changes in costs. Because it is impossible to alter how resources were used in the past, citizens should realize that costs incurred in the past are not relevant to current decision making. Economists refer to these past costs as ‘sunk costs’ and believe that such sunk costs should not be considered in decision making about future resource use. Consider the large dam project that is six months into construction. What if it is discovered that the dam will cause irreparable damage to the agricultural land surrounding it? Economists would say that past decisions only establish the starting points for current decisions about how to use resources in the future. Therefore, if these costs (to agriculture) out-

weigh the expected benefits of the dam, the project should be halted—even though money has already been spent. This is an example of the old adage, ‘don’t throw good money after bad.’

Decision Making and Tradeoffs

A fundamental assumption of economic theory is that people choose rationally. That is, they choose the alternatives that benefit them the most and cost them the least. Careful and systematic decision making involves analyzing tradeoffs and comparing such costs and benefits for each of the available alternatives. Tradeoffs made by society require determining how the costs and benefits of decisions affect different groups within the economy. Choices made by individuals, firms, government agencies, departments or officials often have long-run, unintended consequences that can partially or entirely offset the initial effects of the decision. For example, a firm may produce a product that also produces toxic waste. Does the long-term benefit of the product outweigh the cost of clean-up or disease?

One common tradeoff that societies experience is the ‘security vs. freedom’ tradeoff. Societies that are completely secure (e.g., police states) tend to have little individual freedom, and those in which citizens have complete freedom tend to be very insecure (e.g., anarchy). Benjamin Franklin hinted at this inherent tradeoff when he wrote that “those who would give up essential liberty to purchase a little temporary safety deserve neither liberty nor safety.”⁴³ John Locke also wrote of this ‘liberty vs. order’ tradeoff in his *Second Treatise on Government*. Locke described the social contract between a free people and their government as a tradeoff of some individual rights to the government in return for government protection of other, more essential rights and freedoms.⁴⁴ In Locke’s version of the social contract, the governed give consent to the government to protect rights (such as those outlined in the United States Constitution) by adopting and enforcing laws. James Madison also wrote of this inherent tradeoff when he wrote, in *Federalist 51*, “If men were angels, no government would be necessary.”⁴⁵ Because societies desire neither unlimited freedom nor totalitarian-like levels of security, they must tradeoff some freedom for some security, and *vice versa*. The desirable combination is somewhere between the extremes; exactly where is determined by each society.

A classic economic example of this type of tradeoff can be seen in the often competing economic goals of ‘equity’ and ‘efficiency.’ The tradeoff in this case is the sacrifice of some level of efficiency to bring about more equity, or *vice versa*. Equity can be defined as either procedural (everyone in society is treated equally under the law—the ‘rules of the game’ are the same for all) or as distributional (that some level of income equality exists in a society). It is this latter form of equity that is commonly used in discussions of this tradeoff. Distributional equity was described by John Rawls as the degree that society should be organized to produce an income distribution that provides the highest possible income to the lowest-income individual.⁴⁶ Economic efficiency refers to the degree to which an economy provides the exact combination of goods and services desired by consumers.⁴⁷

The tradeoff between these two goals can be seen in government efforts to improve distributional equity by redistributing income—primarily through taxation and government expenditure policies—from one group to another: from young to old (e.g., Medicare), from those who work to those who do not (e.g., unemployment insurance), or from those without children to those with (e.g., property taxes that pay for schools). Economist Arthur Okun described this process as a ‘leaky’ bucket in the sense that attempts to redistribute income from higher-income groups to lower-income groups may have a detrimental effect on overall efficiency. Okun’s argument was that if—through redistribution efforts—a taxi cab driver and a doctor were compensated the same, individuals would have little incentive to acquire the specialized

skills needed to be a doctor and, because specialization can increase productivity, society would suffer productivity losses, thus reducing overall well-being.⁴⁸

However, a society that fails to meet the most basic needs for all its citizens may be ripe for political and social unrest. In order to prevent this unrest, then, societies should willingly tradeoff some efficiency for some level of distributional equity. In addition, experimental studies have found that when efficiency versus equity questions are put to a ballot, a majority often votes for equity, even though they bear a personal cost due to a loss of efficiency.⁴⁹ Regardless of these differing views the question of equity vs. efficiency, however, it is clear that the basic tradeoff continues to exist.

Most choices and tradeoffs—especially ones such as equity versus efficiency or freedom versus security—are not all-or-nothing propositions; instead they typically involve incremental (economists call these marginal) changes; a little more of this for a little less of that. Decisions about small changes at the margin tend to be made more often than decisions about big changes, and are usually easier to assess.

Marginalism

Marginalism was first discussed at the end of the nineteenth century by the British economist Alfred Marshall. Marshall gets the major credit for developing this “economic way of thinking” because he most clearly and comprehensively applied marginal analysis to a wide variety of issues, and established the marginalist tradition that has dominated economic thinking for more than a century.

The essence of marginalism is analysis of small, incremental changes as the focus of inquiry. Marginalism stresses that past decisions (what economists call ‘sunk costs’) should have no impact on present decisions. A marginal analysis should ask only if the additional benefits of a decision outweigh the additional costs associated with that decision, even if benefits exceed the costs by a smaller margin than before. Marshall argued that an incremental step should be taken as long as the additional benefit of that step outweighs the additional cost of that step, until the additional benefit is just equal to the additional cost.⁵⁰

Many current public policy controversies illustrate this marginal approach to tradeoffs. For example, imagine that a local lake has been polluted to the point where fish are dying. If the community chooses to devote resources to cleaning up the lake, the question is how clean should the lake be? Should it be 100%—that is, perfectly—clean? Eighty percent? Fifty percent? Marginal analysis tells us that the efficient decision is the point where the benefit associated with the next increment of clean up is just equal to the cost of that additional increment.

Should scenic wildlife refuge land be used for oil exploration and extraction? If the land is used for petroleum production, the opportunity cost is the foregone benefits of wilderness. If the land is used for wilderness, the opportunity cost is the lost value of the petroleum that society foregoes. Should government devote additional resources to the criminal justice system (police, courts, and prisons) or to the next best alternative: more education (teachers, books, and schools)? If society devotes more resources to the criminal justice system, other things equal, the opportunity cost is foregone improvements in education. If more resources are allocated to education, the opportunity cost is the foregone benefits from an improved criminal justice system. If society decides to devote more resources to both, what other goods and services must be foregone? Should the federal government increase expenditures on national defense as a proportion of its budget? If so, what other areas will need to be decreased? Within its budget, should the Department of Defense increase its research and development spending of a missile defense system at the expense of funding for conventional weapons systems?

Such tradeoffs are often seen in the public arena in the phenomenon known as *logrolling*. Logrolling describes the political process of vote trading. Consider, for example, two particular bills that may not have the votes to pass on their own. If a representative feels that one bill has great potential benefits for her constituents, while the other bill will incur small costs to her, she might be willing to trade her positive vote on the bill with small costs for another representative's positive vote on the bill with great potential. As long as the net benefit to her of these two bills is positive, this tradeoff will occur.

Enduring Issues

- What is the correct balance between distributional equity and economic efficiency and what is (should be) government's role in determining that balance?
- What are the additional benefits received from legislating tougher environmental laws? What are the additional costs? Do the additional benefits exceed the additional costs?

Public Policy Question

Read the following scenario. Explain the process that should be followed to make a decision on the best use of the limited funds.

The major agenda item on a city council meeting is how to allocate a budget of \$150,000. The council would like to buy five new police cars at \$30,000 each, repair two senior citizen centers for \$75,000 each, and build two new tennis courts at \$75,000 each. Explain why a choice must be made, decide how the city council should spend the \$150,000, describe the tradeoffs made, and identify the opportunity cost of the decision.

Economics Lessons

Unit 2 Lesson 11– Do Prices Matter to Consumers?

Capstone: Exemplary Lessons for High School Economics—Teacher's Guide

This lesson demonstrates how people use prices when they weight expected costs and expected benefits in making economic decisions. It helps students see how choosing a second-best good or service can in some cases improve their overall well-being.

Grade(s): 9-12

Unit 5: Lesson 28 - The Economics of Voting

Capstone: Exemplary Lessons for High School Economics - Teacher's Guide

Students examine a visual to identify patterns of voter turnout in U.S. presidential elections. They analyze the costs and benefits of voting and discuss how people's voting behavior is influenced by incentives.

Grade(s): 9-12

Lesson 2 - Economic Decision Making

Economics in Action: 14 Greatest Hits for Teaching High School Economics

Students brainstorm ways to allocate a scarce good within the classroom. Then they work with a decision-making model that helps them make a decision about this allocation by showing them how to evaluate the merits of each alternative. Finally, students classify examples of market, traditional and command economic systems.

Grade(s): 9-12

Lesson 6 - The Economic Way of Thinking: Three Activities to Demonstrate Marginal Analysis

Economics in Action: 14 Greatest Hits for Teaching High School Economics

This lesson consists of three activities that demonstrate different applications of marginal analysis. You may use the activities separately or do them together in one class period. In the first activity, the students produce a good and demonstrate the law of diminishing marginal returns. In the second activity, a student consumes a good and demonstrates the law of diminishing marginal utility. In the third activity, the students participate in an environmental- cleanup project that demonstrates the importance of comparing marginal benefits with marginal costs when making decisions.

Grade(s): 9-12

Theme 1: Lesson 2 - The Economic Way of Thinking

Financial Fitness for Life: Bringing Home the Gold - Grades 9-12 - Teacher Guide

Lesson 2 introduces students to the economic reasoning process or the “economic way of thinking.” Students reason through two situations, using The Handy Dandy Guide, a primer on economic reasoning.

Grade(s): 9-12

Unit 4 Lesson 14—Do Economic Forces Lead Immigrants to the United States?

Civics and Government Focus: Economics

Students individually or in groups interview a recent adult immigrant to the United States, identifying his or her reasons for leaving the home nation and the reasons for coming to the U.S. The class views and discusses recent data on the major source nations of immigration to the United States, and some relevant economic data about each of these nations. Combining the interview with the economic data provided in class, the students construct and compare two lists—the benefits of migrating to the U.S. and the costs of doing so, each with an emphasis on economic reasons. The lesson concludes with the students developing a description and explanation of the type (and perhaps even some names) of nations that may be major sources of future immigration to the U.S.

Grade(s): 9-12

Stability

Nexus Statement

Liberal democracies seek to maintain stability through both the governmental and economic systems. By stability, we mean both the quality of dependability and the absence of extreme fluctuations in both government and the economy. For example, the governance and economic systems must function dependably and avoid extreme episodes of inflation and recession.

Rationale Statement

Maintaining stability, while simultaneously sustaining democracy, is an important task for the government of a democratic society. Without, “domestic Tranquility,” government cannot “establish Justice,” “promote the general Welfare,” nor “secure the Blessings of Liberty.”⁵¹

There are many facets to the idea of stability, some of which are discussed elsewhere in this document. For example, police power (“...the sovereign right of a government to promote order, safety, security, health, morals, and general welfare...”⁵²) is plainly crucial to the stability of a democratic society. While authoritarian regimes also use police power to establish stability, albeit stability without the prospect of change, they do so without the constraints of safeguarding human rights. Here, we are concerned with a few key ideas in maintaining political stability that are especially important to democracy: peaceful transference of power, institutional practices, and a legal framework.

Economic stability also has emerged as a crucial task of government. The German hyperinflation of 1923 is widely regarded as an important factor in Hitler’s ascent to power. The worldwide depression of the 1930s fomented discontent that is seen as contributing to the rise of the fascist dictators. With the conclusion of the Second World War, the United States Congress immediately returned to the bitter aftertaste of the previous decade of economic depression and passed the Employment Act of 1946: “The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government ... to promote employment, production, and purchasing power.” With this, promoting economic stability became a responsibility of the national government.

Standards

Economics Standard #19:

Unemployment imposes costs on individuals and nations. Unexpected inflation imposes costs on many people and benefits some others because it arbitrarily redistributes purchasing power. Inflation can reduce the rate of growth of national living standards because individuals and organizations use resources to protect themselves against the uncertainty of future prices.

Economics Standard #20:

Federal government budgetary policy and the Federal Reserve System’s monetary policy influence the overall levels of employment, output, and prices.

Grades 9-12 Civics Standard I.B.2:

Students should be able to ... explain alternative ideas about the purposes and functions of law such as providing order, predictability, security, and established procedures for the management of conflict.

Grades 9-12 Civics Standard I.A.3.:

Students should be able to ... explain competing ideas about the purposes of politics and government, e.g., enhancing economic prosperity.

Benchmarks

- Citizens can use this knowledge to:
 - Recognize the importance of peaceful transference of power and explain the role of legitimacy.
 - Identify institutional practices that contribute to stability.
 - Explain the role of common law in a democratic society.
 - Trace the historical development of government's role in promoting economic stability.
 - Explain the purpose of monetary and fiscal policy and how they work to maintain economic stability.

Content Summary

Political Stability: Transference of Power

In all societies power must eventually be transferred from the current ruler to his/her successors. Sometimes the transfer of power is completed peacefully. As history shows, often it is not. Despite the fact that a leader may be named as the “heir to the throne,” civil war can erupt between factions supporting rivals. The potential for destructive instability is so great that most societies have sought to institutionalize the method for transferring power.

Democratic societies face this need to transfer power, and they must do so peacefully despite the possibility that nearly half the population might be very displeased with the results of the most recent election. When George Washington left the office of president, that he was replaced without difficulty by John Adams, just as prescribed by the Constitution, was remarkable. Kings did not retire, and their successors were not democratically selected. This was something new in the post-Enlightenment world. Today, such a peaceful transfer of power seems routine in democracies across the world.

And yet, the occasional reminder surfaces, even in the United States, that it is the legitimacy of the process that undergirds the peaceful transfer of power in a constitutional democracy. In the election of 2000, Florida voting irregularities called into question the legitimacy of the election of George W. Bush. Serious questions were raised about whether the election had been fair. Political analysts muttered darkly about a looming Constitutional crisis (which never materialized).

In April, 2002 events surrounding the presidency of Hugo Chavez in Venezuela show how fragile the process can be. After three years in power, Chavez was forced out by the military, and then was briefly replaced by first one man and then another, before regaining power a few days later. Citizens in Nigeria, which has never in its history experienced peaceful transfer of power, re-elected president Olusegun Obasanjo in an election marred by charges of fraud and vote-rigging. In Ukraine president, Viktor Yushchenko, won office only after protestors filled the streets demanding another election, subsequently ordered by the Ukrainian Supreme Court. During the first election in 2004, Yushchenko was nearly killed by dioxin poisoning.

Political Stability: Institutional Practice

One difference in the recent election controversies in the United States and Venezuela or Nigeria or Ukraine is found in the degree of institutional practices that have been established. In the United States, some people disagreed with the decisions issued by the Supreme Court concerning the election of Bush. But no one disputed the authority of the court to make these

decisions. Indeed, there were numerous rulings by several courts throughout the election process. The power of the courts to make such rulings was accepted by all because the role of the courts to interpret the law had become firmly entrenched in institutional practice.

A nation's constitution cannot spell out every mechanism, every nuance, of how government is to function. Yet, how government is to operate is a crucial element in achieving stability. Much of what citizens of democracies now accept as routine is the result of institutional practices, some of which were established early in the history of their respective nations. In the United States, the "cabinet" (the combined secretaries of the departments, such as the Department of Justice) was not prescribed by the Constitution—George Washington invented the president's cabinet. All of the rules and procedures of the House and Senate had to be created, most of them during the 1st Congress. Imagine the confusion if the route by which proposed legislation becomes law in a nation's legislature is not precisely clear. Likewise, the methods of the Supreme Court—how to decide which cases the court hears, the assignment of opinions by the chief justice, how cases are argued before the court, and so on—are now accepted as the way the court conducts its business, ensconced in institutional practice.

Liberal democracies also attempt to maintain political stability through the laws passed by legislatures. Statutory laws (those passed by elected officials) balance the contending interests of different groups and present an avenue for people to have government address the problems they perceive. A legislature maintains stability through its responsiveness to the public.

Political Stability: Legal Framework

Equally important to establishing a legal framework for stability are those laws relating to contracts and property rights, which are discussed in the "Rights" section of this document. In the liberal democracies that adopted aspects of the English legal system, much of the legal framework of property rights and contracts is established in common law, the system of legal precedents and case law that clarifies and sometimes fills in gaps left by laws passed by legislatures. Common law contributes to stability, particularly economic stability, by presenting a means for peacefully resolving disputes.

Imagine a society in which there was no way to enforce contracts. The uncertainty involved in every potential transaction would become an anchor drowning economic activity. Few would be willing to buy or sell from someone whose reputation was unknown—the product might be defective, or payment might not be forthcoming. In fact, thanks to the legal framework established by government, a person can make Internet purchases with companies from across the world with reasonable assurance that they will deliver as promised. The companies expect the purchasers' credit cards to be valid. The legal precedents in common law support much of this.

Economic Stability: Dampening the Business Cycle

As we will see in this section, liberal democracies are concerned with a broader aspect of economic stability—the recurring but unpredictable swings of economic activity. A significant example of this is found in the United States, whose experiences with recessions and inflation are common to liberal democracies with market systems throughout the world.

Monetary Policy

In the early 1900s, the United States Congress turned its attention to the stability of the banking system. Banking panics had been a chronic feature of the United States economy, with major panics occurring in 1819, 1837, 1857, 1873, 1893, and 1907, and "incipient pan-

ics” in 1860, 1861, 1884 and 1890.⁵³ Panics occur when people, fearful of current economic conditions or based on rumors of financial instability of a bank or its imminent failure due to unsound practices, attempt to withdraw all of their money from their banks. Banks do not hold enough cash to cover all of their deposits, nor is it necessary that they should. After all, banks make money by lending deposits out; their major assets are outstanding loans, which cannot be quickly called in and converted to cash to repay depositors. Banks are referred to as *financial intermediaries* because they act as an intermediary between those with money to lend and those who want a loan. So, when a “run” on a bank began, rumors spread quickly, and depositors rushed to get their deposits. A run on one bank could become runs on other banks, with a general bank panic ensuing.

It is little wonder that, following the panic of 1908, Congress decided to do something. The result was the Federal Reserve Act, signed into law on December 1913 by Woodrow Wilson. It was intended to be the stabilizing influence on the financial system that would end panics and maintain stability. Acting as lender of last resort, the Federal Reserve System was to provide short-term loans of cash to banks to cut short panics (since people will stop withdrawing their money when they find out they can easily get it), oversee banking practices, and generally promote financial stability.

Then came the Great Depression. In this major test of the Federal Reserve, it failed to halt a major panic in 1930, two in 1931, and another in 1933. Worse, although it had the power to do so, it failed to offset the resulting decline in the money supply. The drop of about one-third in the quantity of money was matched by a similar drop in prices and Gross Domestic Product (GDP—the broad measure of how much an economy is producing) from 1929-1933. The consensus among economists today is that Federal Reserve policies were a major contributor to converting a sharp, but not abnormal, recession into the worst depression in American history.⁵⁴ Moreover, because of some features of the international trading system at the time, the depression in the United States contributed to depressions in other countries.

Since then, two especially notable changes have occurred. The first is that in 1933 Congress created the Federal Deposit Insurance Corporation (FDIC) whose primary function is to insure deposits in member banks. Since people’s deposits are insured, there is no reason to panic when a bank is rumored to be unsound or when an economic downturn begins. The FDIC has proved to be an admirable solution to the panic problem—no widespread panic has occurred since its inception.⁵⁵

The other change is that the Federal Reserve has become noticeably more adept at implementing monetary policy. It has several tools at its disposal to regulate the growth of the money supply and change interest rates.⁵⁶ By doing so, it can rein in inflation, as it did in the early 1980s, or attempt to combat recession or slow economic growth. That is not to say that the Federal Reserve is without its critics. For example, some argue that the aforementioned inflation was a result of poor policy-making in the late 1970s. Then, the critics charge, when the Federal Reserve reversed course and decided to fight inflation, they overdid it, producing a recession.

Throughout the world, liberal democracies have created central banks that employ essentially the same tools as the Federal Reserve to maintain stability⁵⁷. It is well known, and has been documented throughout history, that excessive monetary growth produces inflation. Its most virulent form, hyperinflation, is enormously destructive. For instance, in Bolivia the annual price increase in 1985 exceeded 10,000%; Ukraine, 1993, 5000%; Bulgaria, 1997, 2000% in March alone! The most famous example, of course, is the German hyperinflation, where in 1922-23 prices rose so rapidly that workers were paid daily—rushing out to spend their pay before it became valueless. By late 1923, \$1 was equal to 1 *trillion* marks which had

ceased to have any real value. The hyperinflation, its attendant economic instability, and the political instability it helped to produce are still seen as significant factors in the rise to power of Adolph Hitler.

It is, therefore, no surprise that maintaining price stability is a key objective of monetary policy. While no one disputes that a central bank's tight money policies can reduce inflation (or trigger a recession), some believe that the Federal Reserve's tools are relatively impotent in attacking a recession. It is like "pushing on a string." Economist Gary North explains:

"Pushing on a string" is a phrase that has been around for over half a century. It refers to the ineffectiveness of Federal Reserve monetary policy: specifically, the FED's expansion of monetary reserves. It is said that the FED can add to its own reserves by purchasing assets—usually, government debt—but commercial banks will not take advantage of these reserves by lending out money. So, the FED's policy will not jumpstart the economy. The FED can make reserves available, but it cannot force banks into converting these reserves into loans. Like a string—unfrozen, anyway—the FED's pushing on one end does not produce forward movement on the other end.⁵⁸

Thus, to combat a recession, some argue, fiscal policy is required.

Fiscal Policy

Fiscal policy also traces its lineage to the Great Depression and the theories of a John Maynard Keynes for combating it. The idea, in simple terms, is that during recessions investment spending by businesses and consumption expenditures by the public are below what is necessary to fully employ the resources in the economy. During periods of inflation, the reverse is true; spending by consumers, businesses, and government exceeds the ability of the economy to produce the desired goods and services with its available resources.

Fiscal policy is an attempt to manage aggregate demand (total spending by consumers, businesses and government) by changing government spending, taxes, or both. To combat a recession, the fiscal policy prescription is for more aggregate demand—lower taxes to stimulate consumer and business spending or more government spending. To fight inflation, the fiscal policy solution is the opposite. Since aggregate demand is presumably too high, taxes should be raised or government spending reduced.

As with monetary policy, there are disagreements among economists about fiscal policy—some about whether the theory is sound; others about whether it can work in practice. For example, one argument is that a tax cut or increase in government spending that results in a government deficit will raise interest rates and, therefore, "crowd out" private investment and consumer spending. Others have pointed out that, as a matter of real-world practicality, Congress and the president only use fiscal policy as a tool to combat recessions, not to fight inflation (which they are content to leave to the Federal Reserve). Spending increases and tax cuts are, after all, politically popular where spending cuts and tax increases are not.

Despite these disagreements, fiscal policy remains a prominent tool to promote economic stability. The United States employed it to invigorate the sluggish economy at the turn of the 21st century.

Enduring Issues

- Peaceful transference of power in a democracy depends upon the citizens' confidence in the legitimacy of the electoral process by which new leaders are selected. That confi-

dence can be undermined by the perception that elections are unfair. What can government do to enhance the fairness of elections?

- Some have argued that there is little real transference of power in national legislatures. Incumbents have such an overwhelming advantage that election is tantamount to a lifetime appointment. On the other hand, long-serving legislators accumulate great expertise that is lost when they leave service. How much of a problem is this and are term limits a viable solution?
- Some argue that in the long term, price stability is the most important goal in economic stability. Others think that fighting recession should always take precedence. Should there be a “bias” in monetary and fiscal policy; that is should policies lean more toward one goal than the other?

Public Policy Question

How useful are *discretionary* monetary and fiscal policies, (that is, the intentional altering of the money supply, interest rates, government expenditures, and taxes by policy makers)? This is a continuing public policy question concerning maintaining stability. One reason for this question is that there are time lags in employing fiscal and monetary policies. For example, there is the recognition lag—the economy might be headed into a recession months before the data so indicate. There is a decision lag during which policy makers have to agree on a course of action. Obviously, this lag can be especially long for fiscal policy given the need for agreement among the executive and legislative branches in some countries. Finally, there is the lag before the policy actually achieves results. Monetary policy might take many months before its effects are fully felt. With fiscal policies, it could be several years.

The fear is that by the time all of these lags play out, the reason for the policy might have passed. For example, the economy might be in recovery before the anti-recession medicine actually takes effect. This means that the policy turns out to reinforce the current economic cycle—that is it might be *pro*-cyclical, not *counter*-cyclical—and monetary and fiscal policy might become sources of instability rather than stability. Further, fiscal and monetary policies are likely to affect domestic interest rates and the international value of the dollar. This will have net export effects that, in some cases, will increase (not decrease) the instability of the business cycle.

Would governments be better off taking discretion out of monetary and fiscal policy? Should the central bank instead accommodate an average annual economic growth rate of, say, 3-5% per year by making the money supply grow at about that rate, year in and year out? Should the legislature balance the national government budget annually?

Economics Lessons

Unit 3: Lesson 8 - To What Extent Do Economic Conditions Determine the Outcome of Presidential Elections?

Civics and Government: Focus on Economics

Students consider how economic performance is evaluated and are introduced to four major indicators of macroeconomic performance: growth rate of real income, unemployment rate, inflation rate, misery index. They complete a worksheet comparing changes in these indicators with the outcomes of U.S. presidential elections from 1960 to 1992 and examine the influence of economic conditions on the likelihood of the incumbent party winning an election.

Grade(s): 9-12

Unit 3: Lesson 6 - How Can Changes in the Federal Government’s Budget Stabilize the Economy?

Civics and Government: Focus on Economics

The teacher discusses with the class how a market economy like that of the United States goes through the Business Cycle of unstable swings in economic activity. The students then write and perform a three-act skit which illustrates how the level of income and spending in an economy can fall, and how intentional fiscal policy changes in the spending and taxing levels of government result in a multiple impact on the economy.

Grade(s): 9-12

Concepts: Income-spending chain, Multiplier effects, Business cycle, Unemployment, Inflation, Fiscal policy,

Lesson 8: Central Banking With or Without Central Planning

Focus: Economic Systems

Students participate in an auction to see how large increases in the money supply can cause inflation. Then they examine data on the relationship between inflation and growth rates in the money supply in different countries. That leads to a discussion of central banks and monetary policy. Finally, students plot a scatter diagram to investigate the relationship between the political independence of central banks in different nations and historical data on inflation in those nations.

Grade(s): 9-12

Unit 3: Lesson 11 - What Can the Government Do About Unemployment?

Civics and Government: Focus on Economics

An understanding of the three types of unemployment and the various policies government can pursue to alleviate unemployment is developed. Students categorize examples of unemployed workers as structural, cyclical, or frictional unemployment.

Grade(s): 9-12

Unit 3: Lesson 7 - Who Should Control the Money Supply - the U.S. Congress or the Federal Reserve?

Civics and Government: Focus on Economics

Students learn that the basic U.S. money supply consists of currency in circulation and checking account balances in banks. They learn that the money supply increases when banks make loans, and that by controlling bank lending activity, the Federal Reserve System (an independent regulatory agency established by Congress in 1913) attempts to control the supply of money in the economy.

Grade(s): 9-12

Lesson 10: Macroeconomic Stabilization Policies and Institutions

Focus: Institutions and Markets

This lesson begins by reviewing the discovery and adoption of Keynesian fiscal policies in the United States and other nations following World War II. Students then participate in several exercises to ascertain their understanding of appropriate demand-side tools of fiscal policy, which is conducted by national legislative and executive branches of government, and tools of monetary policy, which is conducted by a nation’s central bank (in the United States, the Federal Reserve System).

Grade(s): 9-12

Lesson 4: Klips And Kupons

Economies in Transition: Command to Market

The students participate in the Klips and Kupons simulation. During the simulation, they discover how a change in the money supply can cause changes in the price level. They formalize this discovery by relating the equation of exchange to their simulation results. Some of the consequences of inflation and hyperinflation are examined.

Grade(s): 9-12

Lesson 11 - Money and Inflation

Economics in Action: 14 Greatest Hits for Teaching High School Economics

Students observe a simple demonstration to determine the functions that money performs. They next participate in two rounds of an auction illustrating how increases in the money supply lead to inflation. They view an active demonstration of the equation $MV = PQ$ to understand the relationship among the variables and the intent of monetary policy.

Grade(s): 9-12

Market and Government Failures

Nexus Statement

The performance of both market economies and liberal democracies sometimes falls short of the ideal. These shortcomings are often referred to as market or government “failures.”

Rationale Statement

Market economies and liberal democracies have spread across the globe in much of the last quarter of the 20th century, based in no small way on their success in delivering freedom and material well-being to the citizens in the countries where they have flourished. This is especially true when compared to authoritarian regimes and command economies. However, market systems and liberal democracies are not without their limitations. Winston Churchill is often quoted as stating: “It has been said that democracy is the worst form of government except all the others that have been tried.” Similar things have been said about market economies.

Citizens in liberal democracies with market economies need to understand the limitations of their political and economic systems. They should realize the ways in which their governments and economies may fail to measure up to idealized expectations.

Standards

Economics Standard 16:

There is an economic role for government in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

Economics Standard 17:

Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

Civics and Government Standard 9-12: III.B.1:

Students should be able to evaluate, take, and defend positions in issues regarding the major responsibilities of the national government for domestic and foreign policy.

Civics and Government Standard 9-12: III.E.6:

Students should be able to evaluate, take, and defend positions about the formation and implementation of public policy.

Benchmarks

Citizens will use this knowledge to:

- Identify and evaluate the benefits and costs of alternative public policies, and assess who enjoys the benefits and who bears the costs.
- Explain why there is a role for government in dealing with pollution, vaccinations and medical research; recommend what this role would be.
- Identify some public policies that may cost more than the benefits they generate, and assess who enjoys the benefits and who bears the costs. Explain why the policies exist.

- Explain the statement: Removing rent controls in New York City is good economics but bad politics. Also, explain who would gain and who would lose as a result of 10 percent ceiling on credit card interest rates.
- Explain the major responsibilities of the national government for domestic policy and how domestic policies affect their everyday lives and their community.
- Evaluate competing arguments about the proper role of government in major areas of domestic and foreign policy, e.g. regulation of business and industry.

Content Summary

Market Failures

Competitive markets are efficient to the degree that they provide the amounts of goods and services that consumers desire.⁵⁹ However, there are reasons markets can fail to efficiently provide goods and services. Three reasons for these ‘market failures’ are (1) an uncompetitive market structure, (2) society’s desire to have so-called “public goods” produced and consumed, and (3) the presence of external costs or benefits associated with production or consumption of a good or service. These market failures will not provide the same amounts of goods and services as will a competitive market.

Market failures can occur when markets are not perfectly competitive. Some industries (e.g., breakfast cereals, software for computer operating systems) might have only a handful of producers. In the extreme case of a monopoly, there may be only one. In these cases, producers tend to produce less output and charge higher prices relative to a competitive market. These are cases where there are key roles for government to play in promoting and maintaining more competitive markets. One example of the federal government promoting competition was the Sherman Anti-Trust Act of 1890 which outlawed such anti-competitive practices as collusion between firms, price-fixing, production quotas, or firms blocking free entry of other firms into a market.

A natural monopoly is present when a market with just a single producer actually results in the lowest production costs. One illustration is the public utilities industry. It would be prohibitive costly to have, say, two electric utilities competing to serve a single city. Each firm would have to build its own power plant, its own set of electric lines would have to be run to each home, and so on. Because each plant would likely be utilized at less than its’ full capacity, higher prices would likely result. Allowing a single producer to supply electricity will not necessarily result in lower prices, however. An unregulated monopolist (natural or otherwise) will tend to lower output and set prices above a competitive market level. Again, the government (particularly through regulation) can play an important role in restoring competition (or at least competitive pricing) to such a market. This is often achieved by allowing a single firm (e.g., the electric utility above) to supply the market, but regulating the firm so that it produces at near competitive market prices and levels of output.

In competitive markets, information available to consumers and firms is said to be perfect: that is, it is costless and complete. In fact, information is often incomplete and gathering it can be very costly. For example, one cannot know the lowest price for a particular car without considerable searching. In any number of complicated arenas, such as pharmaceuticals or food quality, society has decided that information is too costly to leave to the market. One might presumably learn over time (by deaths or other horrific side effects) which drugs are effective and safe, but a number of people would have to suffer first, and the information about

the impact of these drugs would be widely scattered and difficult to collect. Often, governments have established regulatory agencies that test and certify drugs and provide information to physicians and the general public; the United States Food and Drug Administration (FDA) is one such example.

Competitive markets also fail to provide the optimal amount of so-called public goods.⁶⁰ Public goods are goods that are said to be both non-rival and non-excludable. Rival goods are those where consumption of the good by one consumer decreases the amount of that good available to another consumer. If I purchase and eat a banana from a local store, then I have reduced the bananas available for the next customer (in the short run). In contrast, non-rival goods can be used by many consumers simultaneously. For example, my listening to a free concert at the local amphitheatre in no way diminishes the ability of other concert goers to hear the concert. Goods for which consumer use can be easily limited are known as excludable goods (e.g., a cover charge to hear a quartet at a small jazz club).

An example of a truly public good (one that is both non-rival and non-excludable) is national defense. Once provided, the protection afforded by national defense cannot be limited (i.e., after a person's tax bill has been paid, he or she is not charged an additional fee for this 'defense'), and one citizen's consumption of 'national defense' does not prohibit others from being protected. Because it is difficult for private firms to exclude benefits from those who fail to pay for the public good (the 'free-rider' problem⁶¹), private firms will generally choose not to provide these types of goods. Because of this, governments may be required to step in to provide such public goods.

Some goods may be either non-rival or non-excludable, but not both. Private firms may produce some of these types of goods, but rarely the amount suggested by competitive markets. This occurs when some portion of either the benefits or the costs of the production or consumption of these goods fall on 'third parties'—individuals other than the primary consumers or producers. Thus, the 'signals' producers get from consumers (or *vice versa*) tend not to reflect the full costs or benefits associated with consumption or production. Air pollution is one such negative 'externality.'⁶² Consider the community that lives downwind from a large corn syrup manufacturing plant. On a day without wind, the odor from the plant is overpowering: residents are forced to stay indoors, property values plummet and general health concerns arise. If the retail price of the corn syrup does not reflect all of these negative externalities, then the firm has 'externalized' the cost of this pollution to the community. Goods with positive externalities include public secondary and post-secondary education because while this education certainly benefits the individual by increasing his or her human capital, it also benefits society; i.e., an educated society is much more likely to have the skills and knowledge necessary for the process of self government.

Government's role in these cases has been debated by economists. In the case of goods with externalities, economist Ronald Coase has argued that if property rights for the common good in question (e.g., the air in the corn syrup factory case; or the pollution that results) can be assigned to private parties (e.g., to the corn syrup plant and the individuals in the community), and they could bargain without cost over the allocation of resources, then they will be able to resolve the externality, resulting in the efficient allocation of resources.⁶³ However, if the parties cannot reach a resolution, then a third party (very often government) must correct for the externality, often through taxes, subsidies, or regulation.

Government Failures

For government to carry out programs that promote competition, provide public goods, or

alter the output of goods and services that provide external benefits, it is necessary to shift the use of productive resources from the private sector to the public sector. This can be done in two ways: confiscation by government or government purchases of the resources in the marketplace. Confiscation can take the form of labor conscription, eminent domain claims on land, or nationalization of capital and other private property. For example, the ‘takings’ clause of the Fifth Amendment of the United States Constitution permits the federal government to take private land if it is in the national interest and if the owner is fairly compensated. Market purchases of resources by government can be financed by money creation, borrowing from the private sector, or using the revenue generated from taxation of income, consumption, or wealth. In any of these cases, productive resources are reallocated from their private owners to government. This reallocation should occur until the benefit of the last dollar moved from the private sector to the public sector is just equal to the cost of doing so.

Unfortunately, democratic government also comes with its own built-in set of failures. Indeed an entire literature of economics and political scholarship, called *public choice theory*, has investigated the limitations of democratic government in remedying problems of the market while revealing some of the inherent limitations of democracy. One such limitation was first proposed by economist Kenneth Arrow and has been called Arrow’s Paradox.⁶⁴ Arrow found that under certain assumptions about people’s preferences between several options, it is always impossible to find a voting rule under which one option emerges as the most preferred.

Among the many insights from public choice theory is the impact of special interests on public policies. Interest groups form around intensely held desires for specific benefits or particular policies—restrictions on a particular foreign import, for example, such as steel, textiles, or autos. Import restrictions increase prices to other industries, such as the cost of steel to a manufacturer of refrigerators, and ultimately to consumers. The total cost of the policy of restricting imports in higher prices to consumers is often greater than the value of the saved jobs. Economist Alan Blinder has written:

Many estimates have been made of the cost of “saving jobs” by protectionism. While the estimates differ widely across industries, they are almost always much larger than the wages of the protected workers. For example, one study estimated that in 1984 U.S. consumers paid \$42,000 annually for each textile job that was preserved by import quotas, a sum that greatly exceeded the average earnings of a textile worker. That same study estimated that restricting foreign imports cost \$105,000 annually for each automobile worker’s job that was saved, \$420,000 for each job in TV manufacturing, and \$750,000 for every job saved in the steel industry. Yes, \$750,000 a year!⁶⁵

The policies were nonetheless enacted because the benefits are highly concentrated among the members of the interest group while the costs are dispersed much more widely among the population. Unions are willing to lobby hard, make political contributions, and rally their supporters through intense efforts to block imports while consumers are largely unaware of the higher prices they pay due to import restrictions.

Public choice theory has also investigated a practice known as *logrolling*, in which “legislators exchange support for the lobby groups they represent among themselves.”⁶⁶ Congressman X agrees to support a highway project in Congresswoman Y’s district in exchange for her support for bridge construction in his district. The benefits of neither of the two projects might be justified by their respective costs. Nonetheless, both are funded.

As noted earlier, modern democratic governments have created regulatory agencies in an

effort to overcome some of the problems of the market system. The United States has dozens of major regulatory agencies—EPA, FCC, OSHA,⁶⁷ and so on. However, as in the case of the protectionist trade policies above, the costs of some of the policies far exceed their benefits. Among the famous historical examples is the Interstate Commerce Commission (ICC) regulation of trucking, which was partially deregulated in 1980. Trucking regulation, in the guise of protecting consumers and providing greater safety, resulted in a complex regulatory structure that set rates, restricted entry into the market (thus limiting the number of firms), and trucks running empty on return trips. Because of these restrictions and the profits to be had with set rates, licenses to haul freight were worth hundreds of thousands of dollars. Deregulation resulted in lowering rates by 25% in just two years and the number of carriers more than doubled in ten years.⁶⁸ Nor is this situation found only at the national level. For years New York City’s regulatory restriction of taxi licenses (medallions) resulted in too few taxis and much higher fares.

What failure of government is at work here? In addition to the influence of special interests, a phenomenon known as *regulatory capture* is possibly the answer.⁶⁹ The regulatory agency is sometimes staffed by former participants in the regulated industry and winds up serving the interests of the industry it is supposed to regulate. Sometimes the problem is the absence of information on which to base regulatory decisions other than that supplied by the industry. There are other reasons for regulatory capture, but in any case, the regulatory agencies fail to fulfill their protective function.

Another instance of regulatory failures can arise because of the incentive to avoid disaster at almost any cost. As noted earlier, today’s liberal democracies regulate the introduction of new drugs to assure safety and effectiveness, presumably due to the complexity involved in deciding whether a drug should be used. As Milton Friedman has argued, however, the regulators would be in great disgrace if they were to approve a drug that turned out to be dangerous and, thus, are apt to be very cautious. Thus, this protection often results in slow introduction of new drugs, perhaps even the banning of drugs that might help many people.⁷⁰ Indeed, it is quite possible that more people are harmed by the protection than are helped.

Liberal democracies cannot always overcome the uncertainty created by the absence of complete information any more than can the market. The regulation concerning asbestos was undertaken with the best of intentions—to remove a known cancer-causing agent from buildings, where it had been for years installed as insulation. However, it has turned out that asbestos removal, in addition to being enormously expensive, may well cost more lives than it saves. As Senator Fred Thompson put it:

Early in the 1980s, government scientists argued that asbestos exposure could cause thousands of deaths. Congress responded by passing a sweeping law that led cities and states to spend nearly \$20 billion to remove asbestos from public buildings. After further research, EPA officials eventually concluded that ripping out the asbestos had been an expensive mistake. Ironically, removing the asbestos actually raised the risk to the public—because asbestos fibers become airborne during removal.⁷¹

Another problem with information is public access to how decisions are made, or *transparency*. Government has grown increasingly complicated, with decisions being made at all three levels of government (national, state, and local), in all three branches of government (legislative, executive, and judicial), and in the independent regulatory agencies.

Citizens too rarely understand how government decisions are made. This lack of

transparency prevents the public from actively participating in government and from raising questions or protesting unfair or ill-advised decisions. A lack of transparency can conceal official graft or favoritism.⁷²

A recent example was the enormous controversy swirling about the meetings of Bush administration officials with corporate leaders to develop US energy policy. Who attended these meetings? What was discussed? How influential were the leaders in developing policy? Were major political contributors given special access?

In the United States, there are some tools for making public the information on policy decisions. The Freedom of Information Act (FOIA) and “sunshine laws” are among these. But, there are exceptions to the FOIA, some say so many that the law inadequately provides for transparency. The Bush administration claimed “executive privilege” in limiting disclosure of the energy policy meetings. Sunshine laws, in force at the federal level and in all the states and the District of Columbia, provide that meetings will be open to the public. But, “executive sessions” are typically closed to the public (There are some good reasons for this), once again limiting access to information.

Perhaps the ultimate source of potential failure in democracy is lack of *accountability*. As Robert S. Barker has written:

In the United States, as in any democracy, the most important guarantee of governmental accountability is the right of the citizens to control the direction of governmental policy and the identity of those who exercise governmental power, through the electoral process. All other constitutional and statutory provisions are but auxiliary measures. Accountable government depends ultimately on responsible citizens or, more precisely, responsible voters, who take public affairs seriously, inform themselves about the issues and the candidates, debate vigorously, vote regularly, and have the moral sense to distinguish right from wrong. Reporting and disclosure requirements and open-meeting laws have their place, but they are meaningless to a complacent, cynical or self-indulgent citizenry. Accountability, like liberty, requires eternal vigilance.⁷³

In the 2000 US presidential election, however, only 49.3% of the voting age population cast ballots.⁷⁴ Many explanations of the recent reality of relative voter apathy have been advanced—negative advertising, the decline of the power of the political parties, etc. But one explanation is relatively simple and straightforward. Some voters, in assessing the costs of staying informed on issues and candidates compared with the benefit to be had by one’s relatively small contribution to the electoral result, don’t think it’s worth it.

No matter what the reason for voter apathy, it is clear that the reality of democracy fails to live up to our image of it. Market systems are imperfect, and so is humankind’s best effort at governance. And yet, in their relatively short histories, liberal democracies and market systems have provided freedom and prosperity unparalleled in human history.

Enduring Issues

- Market systems do not provide adequate incomes for everyone. On the other hand, government programs that redistribute income can diminish the incentives to work and adjust to changing demand for products and services. How can we know what the proper balance is between these competing objectives?

- The right of citizens to band together and petition government for changes is an essential element in liberal democracies. Yet, special interests can frustrate the will of the majority, shape legislation that costs more than the benefits created, and capture regulatory agencies meant to protect the public. What can be done to control the negative impact of interest groups while preserving citizens' essential rights to organize and petition?
- The failure of market systems to reduce negative externalities such as pollution requires the intervention of government. Yet government regulation has its own problems. How can we structure regulatory activity to ensure that costs of regulation do not exceed the accompanying benefits?

Public Policy Question

In 1999, The US government charged Microsoft Corporation with violating Sherman Anti-trust statutes. This case once again raised many of the issues confronted by government in attempting to maintain competition in particular markets. The US government claimed Microsoft was monopolizing the market for desktop operating systems, and using that advantage to engage in other anti-competitive practices. Microsoft claimed that it shouldn't be penalized for being successful (meaning gaining a large market share) and that its real business was software (not just operating systems) in which it had a small global share. Even though the judge ruled against Microsoft, there was a serious problem in deciding what remedy should be enforced.

This case is representative of many problems the government has in establishing policies on competition. Government on some occasions has stopped mergers between companies in order to maintain an adequate number of competing businesses. That fails when one or both of the companies that wanted to merge don't survive. In other cases government regulates the industry—establishing “fair” prices and levels of production. That has failed sometimes, for example, when the regulatory agency is “captured” leading some to argue that the government cure was worse than the problem it was intended to solve.

How can government know when to intervene to make a market more competitive and what remedies it should employ?

Economics Lessons

Lesson 5: Maintaining Competition

Focus: Institutions and Markets

This lesson introduces the rationale for maintaining and strengthening competition, and illustrates the U.S. experience with antitrust laws and other government regulations and agencies. But there are costs and limits to the scope of these government programs, too. A classroom simulation is used to illustrate how difficult it is to maintain collusion designed to limit competition, even in a market where there are only a few producers and no anti-trust enforcement.

Grade(s): 9-12

Lesson 7: Public Goods and Externalities

Focus: Institutions and Markets

This lesson gives students an opportunity to identify the nature of public and private goods, classify them according to the characteristics of rivalry and excludability, experience the impact of free riders and other external benefits and costs, and demonstrate that market-based solutions to externalities are often superior to inflexible government regulations.

Grade(s): 9-12

Lesson 11: No Sacrifice Is Too Great for Someone Else to Make*Focus: Economic Systems*

In this lesson, students are engaged in a production simulation that demonstrates different production decisions about the use of resources under different types of economic systems. Students analyze the results of the simulation to discover that the failure to make producers or consumers pay all of the costs of using the environment leads to pollution in all types of economic systems. That establishes an economic role for government, to reduce pollution up to the point where the additional benefits from pollution reduction are no greater than the additional costs of continuing to clean up the environment.

Grade(s): 9-12Unit 3: Lesson 9 - How Are Economic Solutions to Pollution Different from Political Solutions?*Civics and Government: Focus on Economics*

After students have developed an understanding of externalities, they examine a case study of pollution in Los Angeles and determine a variety of solutions for this problem. The costs and benefits of these solutions are explored.

Grade(s): 9-12Unit 3: Lesson 10 - Why Does the Federal Government Give Money to State and Local Governments?*Civics and Government: Focus on Economics*

The class discusses the meaning of spillover benefits (positive externalities) and develops a list of goods and services provided by state or local governments that could result in positive externalities. The concept of fiscal federalism is discussed by examining why and how the Federal government would encourage state and local governments to increase their production of the items on the list.

Grade(s): 9-12Lesson 5 - The Role of Government In a Market Economy*Economics in Action: 14 Greatest Hits for Teaching High School Economics*

Students brainstorm suggestions about which functions government should perform in a market economy and compare their suggestions with categories economists frequently use. They participate in a quiz activity that shows the characteristics of public goods and explains why certain public goods are best provided by the government. They next participate in or observe a short play to determine when negative externalities exist and suggest solutions for the problem.

Grade(s): 9-12Unit 3: Lesson 12 - Why Isn't Income Distributed More Equally?*Civics and Government: Focus on Economics*

On day one, students review a list of selected occupations and categorize them according to median income. They brainstorm a list of reasons for income differentials and then review a list of conventional economic explanations. They review data on the personal distribution of income in the U.S. since 1950 to see how this distribution has changed over time. On the second day, students discuss various programs and policies used by the Federal government to redistribute income, debating the pros and cons. Finally, they examine data on the movement of families within the distribution and consider ways in which an individual can improve his or

her earning potential.

Grade(s): 9-12

Unit 5: Lesson 27 - The Economics of Special Interest Groups

Capstone: Exemplary Lessons for High School Economics - Teacher's Guide

Students learn about the diverse nature of special interest groups and read examples that show how incentives influence the actions of elected officials.

Grade(s): 9-12

Lesson 7: Shady Creatures and the Problem of Special Interest Groups

Focus: Economic Systems

A trading simulation is first used to demonstrate the benefits of free trade. In a later round trade is restricted, which helps a small group of people but hurts many more. Students use basic arithmetic to see why it would be in the economic interest of the small number of people to support the trade restrictions, but not in the interests of most other people to spend much time, effort, or money to actively oppose the trade barriers. Other examples of special interest issues in different types of economies are then discussed.

Grade(s): 9-12

Lesson 9: Ripples: - Trade Barriers and Unintended Consequences

Focus: International Economics

First in small groups and then in two large groups, students try to identify which people and organizations would support, or oppose, trade barriers on sugar imports into the United States. When these lists have been completed the students are given a one-page reading based on a series of *Wall Street Journal* articles dealing with the actual consequences of such trade barriers from 1985-1990.

Grade(s): 9-12

Unit 3: Lesson 13 - Whose Interest is Being Served?

Civics and Government: Focus on Economics

Students learn the difference between general interest and special interest issues. They play the role of U.S. Representatives and, given information about benefits and costs, vote on enactment of government programs. Then they discuss several government programs and attempt to identify beneficiaries.

Grade(s): 9-12

Concepts: Costs of government programs, Benefits of government programs, Special interest issue, General interest issue, Logrolling,

Lesson 7—How Can Big Business Make Money from Tariffs?

United States History: Focus on Economics

Students investigate the impact of tariffs on businesses and consumers during the 1880s by looking at a political cartoon, solving a short math problem, and comparing protectionism in the 1980s to protectionism in the 1880s. They then generalize about the impact incentives have on encouraging special interest legislation in a democratic government.

Grade(s): 9-12

Unit 4: Lesson 3 - Regulations of Business*United States History: Eyes on the Economy - Through the 20th Century*

Students are presented with an economic mystery. They read and discuss handouts concerning farmers' demands for government regulation of railroads and how the ensuing regulation created incentives which caused the Interstate Commerce Commission to become a "captured" agency. They apply their analysis to the deregulation of airlines and trucking in the late 1970s.

Grade(s): 9-12Unit 5: Lesson 24 - Government and the Environment*Capstone: Exemplary Lessons for High School Economics - Teacher's Guide*

Students examine and discuss visuals to identify an economic mystery regarding the failure of the Endangered Species Act. They are introduced to the concepts of market failure and government failure. Using the Guide to Economic Reasoning, they focus on positive and negative externalities in analyzing the Endangered Species Act as an example of government failure.

Grade(s): 9-12Lesson 13: Public Choice: Economics Goes to Washington and into the Voting Booth*Focus: High School Economics*

Economist James Buchanan won the Nobel Prize in economics in 1987, for pioneering work he had done with Gordon Tullock and others in the new field of public choice economics. This approach applies the basic economic way of thinking to group decisions made through the electoral process or by some government body. That means thinking of voters, elected officials, and government employees as people...

Grade(s): 9-12Lesson 6: Too Much Regulation?*Focus: Institutions and Markets*

In this lesson, students first read an excerpt from *The Jungle*, written by Upton Sinclair in 1906. Then they learn about the numerous regulations that govern the production and sales of a hamburger today, and about some government regulatory offices and agencies. Finally, they consider the question: How much regulation is enough?

Grade(s): 9-12

Regulation

Nexus Statement

When markets fail to work ideally, government may take an active role in correcting such failures, such as imperfectly competitive markets or the presence of externalities. Often in these cases, government attempts to alter less than ideal economic outcomes through regulatory powers.

Rationale Statement

Regulation of economic activities by government may take various forms. One form concerns establishing standards that apply to the production and consumption of goods and services in private markets. Examples of these are setting and maintaining a system of weights and measures, and regulating the value of the nation's monetary units. A second form is concerned primarily with promoting competitive markets and government's attempts to correct market failures. A third form is often referred to as social regulation. These are government policies that address concerns about the conditions under which goods and services are produced, the impact of such production on society, and the physical qualities of the goods and services themselves. Citizens need to know that in a variety of instances, markets can fail to provide the economic outcomes desired by society, or can be less than perfectly competitive and that some government policies attempt to correct for these market failures. Citizens need to know that expanding government's regulatory role in the economy has costs beyond those of funding the regulatory agencies, and that these costs sometimes are greater than the benefits society receives from regulation. Knowledge of all of these will help people make better choices about the appropriate size and scope of government's role in a market economy.

Standards

Economics Standard #9:

Competition among sellers lowers costs and prices, and encourages producers to produce more of what consumers are willing and able to buy. Competition among buyers increases prices and allocates goods and services to those people who are willing and able to pay the most for them.

Economics Standard #16:

There is an economic role for government to play in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

Economics Standard 17:

Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

Grades 9-12 Civics Standard I.A.3.,

Students should be able to ... explain how the purposes served by a government affect relationships between the individual and government and between government and society as a whole..."

Grades 9-12 Civics Standard I.B.2.:

Students should be able to evaluate, take, and defend a position on the importance of the rule of law and on the sources, purposes, and functions of law.

Grades 9-12 Civics Standard I.B.4.:

Students should be able to explain and evaluate competing ideas regarding the relationship between political and economic freedoms.

Civics and Government Standard 9-12: III.B.2.:

Students should be able to evaluate, take, and defend positions in issues regarding the major responsibilities of the national government for domestic and foreign policy.

Benchmarks

Citizens can use this knowledge to:

- Describe government as the formal institutions with the authority to make and implement binding decisions about such matters as the distribution of resources, the allocation of benefits and burdens, and the management of conflicts.
- Identify and evaluate the benefits and costs of alternative public policies, and assess who enjoys the benefits and who bears the costs.
- Explain why there is a role for government in dealing with pollution, vaccinations and medical research; recommend what this role would be.
- Identify some public policies that may cost more than the benefits they generate, and assess who enjoys the benefits and who bears the costs. Explain why the policies exist.
- Explain the statement: Removing rent controls in New York City is good economics but bad politics. Also, explain who would gain and who would lose as a result of 10 percent ceiling on credit card interest rates.
- Explain the major responsibilities of the national government for domestic policy and how domestic policies affect their everyday lives and their community.
- Evaluate competing arguments about the proper role of government in major areas of domestic and foreign policy, e.g., ... regulation of business and industry...

Content Summary

Establishing Standards

Money and a properly functioning monetary system is the lifeblood of a modern, fiat economy. As a medium of exchange, money efficiently facilitates voluntary exchanges between buyers and sellers by providing a system of pricing using a common measure of relative value. Trade within such a system is the very essence of wealth creation. As a unit of account, a stable currency is the measuring stick for the relative value of an economy's resources, goods, and services—and thus for all exchanges.

In the United States the sole power to regulate the “Value” of Money is found in Article 1, Section 8, Clause 5 of the United States Constitution which provides that Congress shall have the power “To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures.”

As early as 1776, however, Congress had begun to create a national system of silver and gold coinage. Thus, under the power “To coin Money,” Congress has discretion to set the weight, purity, form, and impression of all silver, gold, and copper coins it mints. However,

the intrinsic value of the “dollar” is measured by the amount of goods and service for which it can be exchanged.⁷⁵ The framers of the Constitution realized that allowing states to create their own currencies—as they had done under the Articles of Confederation—was inefficient and stifled trade. A single, national currency eliminated many of the costs and inefficiencies involved in trading one state’s currency for that of another.

As American manufacturing adopted industrial forms of organization in the late nineteenth century, the time was ripe for the establishment of a regulated system of national standards for several reasons. The rapid expansion of production specialization by firms in far-flung locations necessitated more accurate measurement standards used in these advancing production processes. Pistons for internal combustion engines mass-produced in Ohio were combined with large quantities of cylinders turned out in Massachusetts. They had to fit! Furthermore, with the advent of the “Age of Electricity,” a greater variety of measures needed standardization than ever before. In the absence of this standardization, American industrial products had become increasingly unreliable.

Standardization in commercial transactions was also badly wanting. As markets expanded, the nation required greater uniformity in its measures. Moreover, consumers also benefited from standardized measures in the marketplace. Establishing the weight of a pound or the volume of an ounce gave consumers a common yardstick against which to measure prices. Industry representatives and scientific societies lobbied for a national standards laboratory such as then existed in many industrialized European nations. On March 3, 1901, President William McKinley signed into law a bill establishing the National Bureau of Standards (NBS). The founding of the NBS was an important part of a quest for a stable, productive, and fair industrial order.

Regulation to Correct Market Failures

The mid-nineteenth century saw what once were local firms expand into regional and national markets. New mechanized production methods that could realize economies of size and scale (efficiencies inherent in some large scale production), sophisticated corporate organizational structures, and vastly improved transportation facilities led to significantly less competition, if not outright monopoly power, in a number of industries.⁷⁶ Firms in these industries used a variety of tactics to gain monopoly positions and then charge monopoly prices to customers and extract price concessions from their resource suppliers. By the last three decades of the 19th century monopolies or “trusts” had emerged in such industries as petroleum, meat-packing, railroads, sugar, lead, coal, whiskey, and tobacco. By the late 1880s and early 1900s, government concluded that market forces in these monopolized industries did not provide sufficient control to achieve a minimum level of competition, protect consumers, and achieve efficiency in the use of resources. The federal government instituted two alternative means of control as supplements to market forces: regulatory agencies and antitrust laws.

Regulatory Agencies

Large-scale operations with very high fixed costs are necessary in some cases to obtain low unit costs and a low product price. When a single producer can supply total output in a market at a cost that is lower than when two or more producers divide production, competition may be impossible. Clear-cut examples of these so-called natural monopolies are relatively rare, but such conditions often exist in some public utilities, such as local electricity, water, natural gas, telephone, and cable television providers. For example, it requires huge turbines to generate electricity at the lowest prices. Dividing electricity production between smaller

plants owned by several firms leads to increased production costs. However, the danger also exists that a single provider could also act as a monopolist.

Because society demands the goods produced by these natural monopolies (e.g., electricity), government regulations then may be used to try to control price, output, and quality. In the few markets where the nature of the product or technology creates a natural monopoly, the government established public regulatory agencies to control economic behavior, namely price and level of output decisions. The Federal government has established the Interstate Commerce Commission, the Federal Trade Commission, the Federal Railroad Administration, and the Federal Aviation Administration, among others. A wide variety of public regulatory agencies have been established at the state, and to a lesser degree, local government levels.

Antitrust laws

Antitrust policy by government is based on the belief that society will benefit if competitive markets are encouraged and monopolies are discouraged or dissolved. Public resentment of trusts that emerged in the 1870s and 1880s culminated in the Sherman Act of 1890 and was extended by passage of the Clayton Act and the Federal Trade Commission Act in 1914. There have been two very significant examples of the application of these regulatory laws over the past quarter century. In the early 1980s, AT&T was charged with violating the Sherman Act by engaging in anti-competitive actions designed to maintain its monopoly of domestic telephone service. An out-of-court settlement between the government and AT&T in 1982 resulted in AT&T agreeing to divest itself of its 22 regional telephone-operating companies. A second case resulted in a Federal District Court ruling in 2000 that Microsoft Corporation violated the Sherman Act through a series of unlawful actions designed to maintain and extend its monopoly of computer operating software. The court's remedy was to split Microsoft into two competing companies that were forbidden to engage in anti-competitive practices. Microsoft appealed the court's decision, and while the ruling of anti-competitive practices was upheld, the lower court was required to change the remedy.⁷⁷

Product and Manufacturing Regulation

In the early 1960s a new type of regulation began to appear. This regulation was concerned with the conditions under which goods and services are produced, the impact of their production on society, and the physical qualities of the products themselves. In certain cases, for example, government might establish product safety standards for important products such as food or pharmaceuticals. In these cases, the need for government regulation arises when the flow of information in such markets, particularly about harmful products, is too slow or too costly for consumers. As a society, for example, we have deemed that people getting sick or dying while waiting for the market to provide information on the safety or effectiveness of a drug is too great a cost to bear.

This type of regulation tends to impact a greater number of firms than other regulation. For example, while the Federal Energy Regulatory Commission (FERC) applies to a relatively small number of firms, Occupational Safety and Health Administration (OSHA) rules and regulations apply "across the board" to firms in all industries. This type of regulation often dictates the design of products, the conditions of employment, and the nature of the production process. For example, the Consumer Product Safety Commission and the Food and Drug Administration regulate the design of potentially unsafe products, while the Environmental Protection Agency (EPA) regulates the amount of pollution allowed during production. Finally, this type of regulation has been expanding significantly during the same period in

which other types of regulation have been on the decline. During the decade of the 1970s, the Federal government created more than a dozen new social regulatory agencies at the same time deregulation of major industries such as long-distance telephone service, airlines, and the trucking industry, to name a few, was taking hold.

Deregulation

A recent trend has been to deregulate the parts of the industries where competition seems possible. Beginning in earnest in the 1970s, issues of unintended consequences of governments' industrial regulation, such as actually reducing rather than increasing competition in certain market, became clear.⁷⁸ Additionally, analysis showed that in a number of cases, the costs to society of this regulation, particularly in the form of lost output from inefficient resource use, were exceeding the benefits being generated. For example, long-distance telephone service, natural gas drilling, wireless communications, cable television, and long-distance electricity transmission have been, to one degree or another, been deregulated over the past several decades. Regulators in some states are beginning to allow new entrants to compete with existing local telephone and electricity providers. However, state and local government regulatory commissions still regulate the prices most local natural gas distributors, regional telephone companies, and local electricity suppliers can charge.

Enduring Issues

- Who are the primary beneficiaries of government regulatory policies, and who are the losers?
- How should the benefits and costs of a regulatory policy be determined? By whom?
- What types of government regulations are most likely to improve the allocation of society's scarce productive resources? What types of government regulations are most likely to interfere with the efficient operation of a private market?
- What criteria should governments consider when deciding to regulate (or deregulate) an industry?

Public Policy Question

The current condition of the commercial passenger airline industry and the markets in which they operate is in flux. Since the 1970s when the federal government removed regulations regarding routes operated and prices charged by airlines, a number of well-known airlines have gone bankrupt. The economic fortunes of others have been erratic. Currently almost all airlines are encountering enormous losses as their costs exceed their revenues. One of the results of these changes and problems has been the consolidation of the industry through corporate mergers at a rate faster than the start-up of some new, small airline companies. As the industry becomes more concentrated, airline consumers are facing problems. There are fewer choices of airlines, with some smaller airports being served by only one or two carriers. This has resulted in a more restricted selection of routes with fewer flights and fewer seats available, and a confusing and constantly changing, often rising, array of prices for consumers. And yet, falling profits and rising losses mount for the airlines.

What, if any, role should government regulation play? Consider how each of the following might view the issue of government regulation in the airline industry:

- Small-town airport owner

- President of the second largest US carrier
- President of a small regional airline
- Frequent business flier
- Occasional flyer

Economics Lessons

Unit 4: Lesson 2 - The Economic Effects of 19th Century Monopoly

United States History: Eyes on the Economy - Through the 20th Century

Students examine a series of visuals and discuss handouts on the economic impact of the “Robber Barons” in the 1890s and today.

Grade(s): 9-12

Guess Who’s Coming to Dinner

Online: <http://www.econedlink.org/lessons/index.cfm?lesson=EM522&page=teacher>

This lesson introduces regulation and information as two tools used by government to promote fair competition and complete information in a market economy. Using the 1906 Pure Food and Drugs Act as a case study, students explore the reasons buyers and sellers asked the federal government to intervene with respect to food safety and quality. In a second activity, students examine how government has improved consumer access to food and nutrition information, more specifically, how government requires sellers to provide accurate, standardized information and how it provides information directly through federal agencies. Students then use this information to make a choice between two food products.

Grade(s): 6-8, 9-12

Lesson 4 - Who Should Make the Food Safe?

United States History: Focus on Economics

Students role-play, participate in a class discussion, and analyze a graph depicting changes in a market to gain insight into ways in which government regulations affect the behavior of producers.

Grade(s): 9-12

Worker Safety - The Triangle Fire Legacy

Online: <http://www.econedlink.org/lessons/index.cfm?lesson=EM542&page=teacher>

The Triangle Shirtwaist Fire of 1911 was a turning point for employee health and safety protections in the U.S. Students investigate the Triangle tragedy and how its impact is still felt today. Students identify eerie parallels between the Triangle Fire and more recent workplace events with safety implications—recent complaints of Wal-Mart employee lock-ins, a deadly fire in a North Carolina poultry processing plant in 1991, and a 1993 fire in a Thailand toy factory given the sad distinction of most deadly industrial fire in the world. How can future tragedies be prevented in the workplace? Students assess the costs, benefits and effectiveness of various government and labor actions. They discover that worker safety is a complex issue and there is no one-size-fits-all solution.

Grade(s): 6-8, 9-12

Deregulation and the California Utilities

Online: <http://www.econedlink.org/lessons/index.cfm?lesson=EM201&page=teacher>

“The verdict is in: California’s experiment with energy deregulation is not just a mess; it’s a certifiable failure, according to everyone from the state governor to the very utilities that initially backed the scheme.” This is how Charles Feildman, CNN Correspondent, began his article on January 4, 2001, entitled “The California Power Quagmire”. Has this happened with any other industry? How and why did this happen in California and can it happen in other states? To understand what happened one must look at some simple and basic concepts in economics.

Grade(s): 9-12

Airline Mergers, Software Industry Monopolies: Contestable Markets?

Online: <http://www.econedlink.org/lessons/index.cfm?lesson=EM22&page=teacher>

Mergers within industries such as banking, telecommunications, and airlines have created a stir among consumers who charge that economic freedom and efficiency are being sacrificed in favor of corporate profits. The theory of contestable markets postulates that firms in imperfectly competitive markets may act as though they operate in a purely competitive market when entry and exit are perfectly ((or nearly) costless. Firms generate a normal profit when faced with the threat of additional market consumers can continue to enjoy the lower prices that accompany competition; the merger between firms and subsequent strengthening of business concentration may not have detrimental effects on consumers. The United States Department of Justice has used this theory on antitrust cases to rule in favor of the defendant. Students will read an overview of the contestable markets hypothesis and determine whether or not it is applicable to the airline mergers and to the Microsoft antitrust case. In this lesson, you will determine whether mergers and monopolies within certain industries have negative effects on consumers based on the theory of contestable markets.

Grade(s): 9-12

Globalization

Nexus Statement

Today the world is organized into some 200 nation-states, each of which claims its own sovereignty. Nation-states do not exist in isolation—each is part of an interconnected world in whose development it plays a role. The sovereignty of nation-states, however, is being profoundly affected by the emergence of a global economic system, including recent rapid growth of international trade that stretches beyond the control of any single state and exerts economic, technological, and cultural influences on individual nations. Sovereignty also is being particularly affected by recent rapid growth of international trade.

Rationale Statement

Increasingly, we live in a global economy where something done in one particular nation affects the rest of the world, and what is done in other parts of the world affects that nation. International exchange of goods, services, and resources is the primary connection among the nations of the world. An understanding of the “win-win” nature of voluntary exchange helps explain why people in the same or different nations trade with one another. This understanding can explain why an economy in which people specialize and trade with one another leads to higher overall levels of production and consumption.

Since the end of the Thirty Years War in 1648, the nation-state has remained the basic political unit of the world and there are now nearly 200 sovereign and theoretically independent nation-states. Increased international trade and economic activity may threaten the basic political structure of the nation-state, however, as sovereign states begin to deal more and more with multinational (or supranational) business enterprises and become increasingly engaged in trade with other nations. On the other hand, trade and the free flow of economic resources, goods, and services are often restricted by the sovereign nations or states of the world, sometimes in attempts to retain their own institutions, governments, laws, and monetary systems.

Standards

Economics Standard #5:

Voluntary exchange occurs only when all participating parties expect to gain. This is true for trade among individuals or organizations within a nation, and among individuals or organizations in different nations.

Economics Standard #6:

When individuals, regions, and nations specialize in what they can produce at the lowest cost and then trade with others, both production and consumption increase.

Economics Standard #17

Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

Grades 9-12 Civics Standard IV.A.1:

Students should be able to ... explain the division of the world into nation-states that claim sovereignty over a defined territory and jurisdiction over everyone within it.

Grades 9-12 Civics Standard IV.A.2:

Students should be able to ... describe the most important means nation-states use to interact

with one another.

Grades 9-12 Civics Standard IV. C.3:

Students should be able to ...

- describe some of the principal economic, technological, and cultural effects the United States has had on the world...
- explain the principal effects of developments in other nations on American society and on their own lives.

Benchmarks

Citizens can use this knowledge to:

- Explain the concept of sovereignty and differentiate between internal and external sovereignty.
- Describe how their daily lives would be different if people in the United States did not trade with people in other countries.
- Explain why China produces relatively more cotton textiles and the United States produces relatively more commercial jet aircraft.
- Explain how a tariff on imported cacao beans affects the production of chocolate candy in the United States and how it affects people in cacao-growing countries.
- Name three things such as bananas, coffee, and eucalyptus oil that could be produced in the continental United States, although production would be very costly, and explain in terms of opportunity costs why the United States is probably better off importing such goods.
- Analyze data on the kinds and value of goods that Japan, Canada, Mexico, and Germany export to the United States and predict the likely effect of a recession in the United States on the economies of these countries.
- Look at historical examples of periods when the United States imposed trade barriers and explain why U.S. citizens would impose trade barriers, given the mutual benefits of free trade.
- Identify the benefits when a trade barrier such as an import quota on sugar or automobiles is eliminated.
- Analyze the political and economic implications of a proposed ban on imported televisions.
- Identify at least three nations against whom the United States has imposed economic sanctions in order to further its foreign policy objectives.
- Describe the foreign policy objectives the United States was attempting to achieve through the economic sanctions.
- Identify the nature of the economic sanctions used in an attempt to achieve foreign policy objectives.

Content Summary

The world's 200 sovereign nations relate to one another in a variety of ways. Citizens of

one nation may own businesses and other forms of property in other nations. Some nations may be at war with other nations. Governments station political, economic, and cultural officials in other nations in order to further better understanding of their nations. Nations belong to a wide variety of international political, economic, and cultural organizations. One way in which nations are connected to one another is through the voluntary trade of goods, services, and resources. The volume of such trade has grown at record rates since the end of WWII.

Between 1990 and 2002, the volume of global trade, as measured by merchandise exports, nearly doubled.⁷⁹ What is responsible for this level of growth? Several factors that might explain such growth are the opening of new, and large, consumer markets (e.g., the former Soviet Union and the People’s Republic of China) and the trend toward reduction in trade barriers through trade agreements such as NAFTA and the World Trade Organization.⁸⁰ This second factor highlights the impact of free trade between nations.

The case for free trade is one that is nearly unanimously supported by economists; in fact, it may be the most commonly agreed upon tenet of economic theory.⁸¹ The reasons for this support are, at least in part, based on the benefits (what economists call ‘gains from trade’) of free trade. Unfortunately, as Alan Blinder (1987) concluded (with tongue firmly in cheek), to “the average citizen—and therefore the average politician—the case for free trade is an abstract intellectual argument made by ivory-tower economists with at most one foot on terra firma. Practical men and women of affairs know that we must protect our vital industries from foreign competition.” (p. 112)

In 1776, Scottish philosopher Adam Smith published his classic economic tome *Wealth of Nations*. In it he wrote:

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost more to make than to buy...If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.⁸²

The advantage Smith referred to is that of comparative advantage. Comparative advantage explains why it may still be beneficial for two countries to engage in trade for goods even though each is able to produce these goods domestically and one of them is able to produce every good more cheaply than the other. According to the theory of comparative advantage,⁸³ it is not absolute cost of production that matters, however, but rather the relative cost at which the two countries can produce different kinds of things. This theory is initially so counterintuitive, a concrete example is necessary to completely explain it.

Consider two nations, Spudland and Citronia, that both produce only two goods: oranges and potatoes. Spudland’s cost to produce one potato is one orange (Spudland must ‘trade-off’ the possibility of producing one orange for the chance to grow one potato). Citronia’s cost to produce one orange is only one-half potato. Thus, Citronia has a *comparative* advantage in oranges. Spudland’s cost to produce a potato is one orange (for the same reasons as above) while Citronia’s cost to produce one potato is two oranges. Spudland holds a *comparative* advantage in potatoes. Comparative advantage suggests that both Spudland and Citronia could be made better off by specializing in the good in which each holds a respective comparative advantage and then trading, rather than trying to produce *both* oranges and potatoes. Consider, for example, the case where Spudland specializes and produces three potatoes and trades two to Citronia which specializes and produces ten oranges and trades three of them for the two Spudland po-

tatoes. Both would now have more of each good than they could produce in isolation.

Table 1. Spudland and Citronia’s Production Possibilities for Oranges and Potatoes

Spudland		Citronia	
Oranges	Potatoes	Oranges	Potatoes
0	3	10	0
1	2	8	1
2	1	6	2
3	0	4	3

The key point is that specialization and free trade based on comparative advantage makes it possible for households to consume more goods regardless of whether trading partners are more or less economically advanced. It should be noted that such ‘gains from trade’ occur in the aggregate; often individuals in industries with a comparative disadvantage (e.g., the US steel industry) are made worse off, at least in the short run. Society as a whole, however, is made better off by such trade. Unfortunately, while politicians and policy makers may understand the gains from free trade that comparative advantage brings, they also have powerful incentives to support policies that benefit their constituencies—often at the expense of the nation at-large. Indeed, trade barriers and trade wars have been all too common in the history of international relations.⁸⁴

Trade barriers

Despite the obvious mutual benefits associated with unrestricted trade among people in different countries, many nations still choose to restrict free trade. These restrictions often are justified for a variety of reasons.

- military self-sufficiency for national security
- increasing domestic employment by restricting imports
- diversifying rather than specializing in order to achieve stability
- protecting new “infant” industries until they can compete internationally
- protecting domestic industries against foreign firms that “dump” their products here at less than full cost in order to win a larger world-wide market share
- protecting domestic workers’ pay against cheap foreign labor.

Economists generally reject most of these arguments as being economically inefficient. They tend to focus on the argument that when imports are restricted by public policies, consumers pay higher prices and job opportunities and profits in exporting firms decrease, all of which leads to economic losses to society as a whole.

Although barriers to international trade usually impose more costs than benefits, they are often advocated for by people and special interest groups that expect to gain substantially from them.⁸⁵ Because the costs of these barriers are typically spread over a large number of people who each pay only a little and may not recognize the additional costs, policies supporting trade barriers are often adopted through the political process. In addition, political action

groups with strong political influence (such as labor unions) have traditionally supported trade barriers in certain industries. This approach to trade policy often fulfills the old saying that ‘good politics makes bad economics.’

Economic Policy and Foreign Policy

From Pericles’ decrees limiting the entry of foreign products into the marketplace of Athens in 432 BC to the United States’ imposition of economic sanctions on Cuba and Iraq in the 20th Century, countries have attempted to use economic policy as a part of their overall foreign policy. Many nations attempt to achieve foreign policy objectives through economic and trade policies. Some examples include the United States’ efforts to convince the USSR to liberalize Jewish immigration in the mid-seventies and the 1980s economic boycott of South Africa designed to end apartheid. Indeed, the use of restrictive trade policies, or economic sanctions, has increased dramatically since 1914. Hufbauer, Schott, and Elliott in *Economic Sanctions Reconsidered* document and study 116 cases of economic sanctions as a part of foreign policy goals from 1914-1990. According to the authors, “[S]anctions are part and parcel of international diplomacy, a tool for coercing [another government] into a particular avenue of response.”⁸⁶ The main types of economic sanctions are the limitation of exports to another country, restrictions on imports from another country, and financial sanctions, including the reduction of foreign aid. However, many foreign policy experts question the effectiveness of trade and other economic sanctions.

Sovereignty of the Nation-State in an Increasingly Global World

Today questions are being raised about the sovereignty of the nation-state. Those questions are of both a political and an economic nature. Some critics dispute the belief that each nation-state should have exclusive jurisdiction over its territory and the right to treat its citizens in whatever way it chooses. They point to instances of environmental damage that extend beyond the borders of any given nation-state.⁸⁷ The destruction of rain forests, depletion of fishing grounds, and reduction of the ozone layer are examples.

Critics also point to historical and contemporary examples of how individuals and groups within a nation-state have been abused, terrorized, and even exterminated, if they are disliked or feared by those who possess the ultimate political decision-making power. Critics argue that nation-states should conform or be held to a higher set of moral principles such as those set forth in international declarations and covenants. One of the earlier statements of acceptable treatment of human beings is the Universal Declaration of Human Rights (1948).

The profound increase in global economic interaction has implications not only for the nation-state but for virtually every individual throughout the world. Several aspects of the increase in international trade have direct impact on the question of sovereignty. First, the nature of international trade is changing. Technology has lowered transportation and communication/information costs, which in turn increases the scale of international trade. Free trade agreements (e.g., the European Union, NAFTA) have lowered barriers to trade, further reducing the costs associated with international trade. In addition to an increase in merchandise trade, international trade in the service sector also has increased (e.g., the export of computer support services to nations such as India). In light of this increasing trend toward ‘throwing open the border,’ it is easy to see how the sovereignty of nation-states may be in question. Finally, trade policies developed by international (or transnational) organizations such as the World Trade Organization may have the effect of usurping power from sovereign states. For example, the WTO has required that member nations eliminate trade barriers and trade poli-

cies such as ‘dumping.’ The requirements may (and have) contradicted the policies of sovereign member nations, forcing countries to decide whether to trade-off some sovereignty for membership.

A final issue related to the growth in the global economy is the real and perceived impact of free trade on less developed nations. One school of thought characterizes free trade, and the economic growth it brings, as benefiting only the developed nations of the world—particularly the industrial west. Jeffrey Garten, Dean of Yale School of Management, for example, focuses on the perceived negative impact of free trade and free markets when he writes “the spread of business across borders may be the most powerful force operating in the world. Today the world’s largest and most successful transnational corporations treat the world as a single marketplace. They produce and deliver goods and services through a global division of labor which has.... consequences for all humanity ranging from environmental concerns and human rights to nuclear proliferation.”⁸⁸

Here it is important to revisit our example of Spudville and Citronia. Recall that in our example, both nations gained from specializing and trading, even though Spudville was clearly less well-developed relative to Citronia. Similarly, increasing economic freedom, including reducing trade barriers, can benefit any nation whether rich or poor. Economic data from nations around the world indicate that there is a strong positive relationship between economic freedom (including free trade) and economic growth and prosperity, regardless of level of development. For example, nation’s with greater economic freedom tend to have, relative to nation’s with less economic freedom, greater life expectancy, lower infant mortality, higher rates of literacy, higher overall standards of living, and lower proportions of their populations living in poverty.⁸⁹ These comparisons are relative rather than absolute, meaning that many nation’s with economic freedom still have lower standards of living than, say, Sweden. But what is important to note is that the relationship between economic freedom and economic success is both strong and positive.⁹⁰ Data also suggest that the relationship between economic freedom and political freedom is both strong and positive.⁹¹ In other words, nations with more economic freedom tend to have more political freedom. This finding echoes the words of political theorist Robert Dahl who concluded that “it is a historical fact that modern democratic institutions ... have existed only in countries with predominately privately-owned, market oriented economies, or capitalism, if you prefer the name.”⁹²

Enduring Issues

- How does the international exchange of goods, services, and resources strengthen relationships between and among nations? How does it weaken sovereignty?
- How do leaders and policymakers make policy for sovereign nations in light of increasingly global political world?
- When should a country sacrifice sovereignty to an international organization (e.g., UN, WTO)?
- How does an increase in international specialization and trade lead to greater interdependence among nations?
- What are the advantages and disadvantages of greater international interdependence?
- Under what circumstances is the imposition by government of trade barriers against other nations justified and desirable?

- Should short term costs (e.g., environmental damage) be incurred for long term gain (sustained increases in standard of living)? Who should make such decisions?

Public Policy Question

Read the following scenario and respond to the questions at the end.

The United States government allows shirts produced in Taiwan to be imported into this country without imposing a tariff on them. Assume that the Taiwanese can produce shirts at half the cost of shirts produced by American manufacturers.

- What groups in the United States and in Taiwan will be helped, and what groups will be hurt, if the United States continues the present free-trade policy toward Taiwan?
- Prepare an argument supporting the American shirt manufacturers' desire for a tariff on Taiwanese shirts. Include a description of what groups will be helped and what groups will be hurt by the imposition of the tariff on Taiwanese shirts.

Economics Lessons

Lesson 1 - Why People Trade

Economics in Action: 14 Greatest Hits for Teaching High School Economics

Students participate in a trading simulation and use this experience to discover the benefits of free trade. In a class discussion, they relate the simulation to concepts of regional versus universal trade, trade barriers and diminishing marginal value. They explain why both parties benefit from the trade.

Grade(s): 9-12

Unit 5: Lesson 4 - Entrepreneurship Case Study: Adam Smith

United States History: Eyes on the Economy - Through the Civil War

Students use statements from *The Wealth of Nations* as primary sources. They discuss distinctions between mercantilist economies and market economies.

Grade(s): 9-12

Lesson 12: Factors Influencing Balance of Payments

Focus: International Economics

Students read a list of various events and transactions. They determine how the events and transactions influence the balance of payments. By reference to Visuals 1 and 2 in Lesson 11, they determine how different transactions influence the demand for and supply of dollars.

Grade(s): 9-12

Lesson 4: Trading Around the World

Focus: International Economics

Students first analyze and discuss information on the major U.S. trading partners. Then they identify the parent countries of businesses that produce familiar brand name products. Finally, students participate in an activity to identify the countries where clothing and other items seen in their classroom were produced.

Grade(s): 9-12

Lesson 7: Shady Creatures and the Problem of Special Interest Groups

Focus: Economic Systems

A trading simulation is first used to demonstrate the benefits of free trade. In a later round trade is restricted, which helps a small group of people but hurts many more. Students use basic arithmetic to see why it would be in the economic interest of the small number of people to support the trade restrictions, but not in the interests of most other people to spend much time, effort, or money to actively oppose the trade barriers. Other examples of special interest issues in different types of economies are then discussed.

Grade(s): 9-12

Lesson 6: Limiting Trade

Geography: Focus on Economics

Students read narrative describing various types of trade restrictions and their effects, engage in a circle debate about the imposition of a new tariff, evaluate the arguments in favor of and against the tariff, and apply the model described in the narrative to determine who will benefit and who will be hurt by the tariff.

Grade(s): 9-12

Lesson 13 - Comparative Advantage and Trade in a Global Economy

Economics in Action: 14 Greatest Hits for Teaching High School Economics

Students observe or participate in a role-play situation in which one person is better at both of two activities. They complete a work sheet that leads to the conclusion that specialization and exchange make both people better off. Then they apply this situation to international trade and to the concepts of absolute advantage and comparative advantage. In small groups, they identify winners and losers from free trade and restricted trade. **Grade(s):** 9-12

Unit 7: Lesson 41 - Why People Trade: Comparative Advantage

Capstone: Exemplary Lessons for High School Economics - Teacher's Guide

The students decide why people buy foreign goods, and they practice measuring the comparative advantage of different producers.

Grade(s): 9-12

Lesson 4: International Interdependence

Geography: Focus on Economics

Students provide information about foreign-made goods that they and their families have purchased, and a master list is compiled. Then they hypothesize reasons why people buy goods made in other countries, and these reasons are also recorded. They are asked whether foreign trade is more important, less important, or equally important to the United States and other countries, and their answers are recorded. Following an activity, which gives them an intensive look at graphical data concerning international trade, the students reconsider their earlier answers and discuss the importance of international trade for the United States.

Grade(s): 9-12

Lesson 10: Why Are Some Nations Wealthy?

Focus: Economic Systems

Students work in pairs to examine data from several nations regarding size, natural resources, and population. Using these data they make predications about which nations are likely to be below, at, or above the world average of per capita Gross Domestic Product (GDP). GDP is

the basic economic measure of national income, so per capita GDP is a key measure of a nation's per person income. Students check their predictions against actual per capita GDP data. They then review and discuss economists' findings about the factors that contribute most to long-term economic growth.

Grade(s): 9-12

Lesson 11: "Hey, Hey! Ho, Ho! Why Do We Need the WTO?"

Focus: Institutions and Markets

Several activities are used to introduce students to six international institutions that play important economic roles, especially in the areas of international trade, finance, and development: the World Trade Organization (WTO), the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the United Nations Department of Economic and Social Affairs (UN...

Grade(s): 9-12

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- ² Stanford Encyclopedia of Philosophy, <http://plato.stanford.edu/entries/liberty-positive-negative/>
- ³ John Locke, *Second Treatise on Government* (1690), accessed on September 1, 2005 at <http://jim.com/2ndtreat.htm>
- ⁴ U.S. Constitution (1791), accessed on September 1, 2005 at http://www.law.cornell.edu/constitution/constitution_overview.html
- ⁵ In the United States, most of the police function is exercised by the individual states, largely through municipal and other political subdivisions. There are some in the United States who argue that this function is constitutionally reserved exclusively to the states; there is no role for the national government in these activities. See, for example, "The Expanding Federal Police Power" at CATO Handbook for Congress retrieved on June 18, 2003 from <http://www.cato.org/pubs/handbook/hb105-17.html>. In other nations, the national government has constitutionally clear authority.
- ⁶ See definition of "police powers" from Law.com Dictionary, accessed on September 1, 2005 at <http://dictionary.law.com/default2.asp?typed=police+powers&type=1&submit1.x=40&submit1.y=6&submit1=Look+up>
- ⁷ See http://en.wikipedia.org/wiki/Civil_society
- ⁸ Alexis de Tocqueville (1805-1859), accessed on September 2, 2005 at http://en.wikipedia.org/wiki/Alexis_de_Tocqueville
- ⁹ Amendment IV: The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.
- ¹⁰ President Carter signed the covenant, but it was never ratified by the United States Senate. See: <http://en.wikipedia.org/wiki/ICESCR>
- ¹¹ See *Nexus: Efficiency and Decision Making*.
- ¹² Europa, "EUSC," retrieved June 18, 2003 from http://europa.eu.int/agencies_cfsp/eusc_en.htm
- ¹³ The countries are Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovakia and Slovenia. See "NATO: Enlargement" retrieved on June 18, 2003 from <http://www.nato.int/issues/enlargement/index.htm>
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- ¹⁸ Bellah, R. *et al. The Good Society* (New York: Vintage Books, 1991) p. 10.
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- ²⁰ Center for Civic Education. *An International Framework for Education in Democracy* (Calabasas, CA: 2003 [in press]) p. 79.
- ²¹ *Ibid*, p. 80.
- ²² George Horwich, "Institutions for Building a Market Economy," in M. Watts, ed., *FOCUS: Institutions and Markets*, New York, NY: National Council on Economic Education, 1.
- ²³ See *Nexus: Rights*.
- ²⁴ Horwich, 3.
- ²⁵ See <http://www.uspto.gov> for more information.
- ²⁶ Defined by the USPTO as certain creations of the human mind that are given the legal aspects of a property right. See <http://www.uspto.gov>.
- ²⁷ "What is a Patent?" accessed at <http://www.uspto.gov/web/offices/pac/doc/general/index.html#functions> on May 1, 2003.
- ²⁸ *Ibid*.

- ²⁹ *Ibid.*
- ³⁰ “What is a Copyright?” accessed at <http://www.uspto.gov/web/offices/pac/doc/general/index.html#functions> on May 1, 2003.
- ³¹ See <http://news.bbc.co.uk/1/hi/entertainment/music/2931589.stm> for a detailed analysis of this issue.
- ³² For a full description of the TRIPS agreement, visit http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm
- ³³ Baumol, William J. and Blinder, Alan S, *Economics: Principles and Policy*. Fifth Edition (San Diego: Harcourt, Brace, Jovanovich, 1991), G-7.
- ³⁴ There are different definitions of this term. This definition from economist Mark Casson (which he labels as “what most people recognize”) is found in his longer article on the history of how entrepreneurship has been conceptualized in economics. Accessed on September 12, 2005 at <http://www.econlib.org/library/Enc/Entrepreneurship.html>
- ³⁵ Microeconomic theory posits four assumptions as the foundation for perfect competition: 1) the number of buyers is so large and their size so small that the actions of any one cannot affect the market; 2) information is perfect (costless and complete); 3) that products and services in a market are homogeneous; and 4) firms have freedom of entry and exit from the market. Obviously, many markets fail to meet these assumptions to one degree or another. Thus, much of economics is devoted to exploring what happens when these assumptions are violated. The significance of efficiency to economists is evident in these investigations. For example, the real sin of monopoly is that resources are “misallocated,” since (in general) less of a good is produced than there would be under competitive conditions. Problems such as these are discussed in *Nexus: Failures*.
- ³⁶ Blinder, Alan S. *Hard Heads, Soft Hearts: Tough-Minded Economics for a Just Society* (Reading, MA: Addison Wesley, 1987) pp 14-15.
- ³⁷ Bahmueller, Charles F. *Civitas: A Framework for Civic Education*, (Calabasa, CA: Center for Civic Education, 1991) p. 14.
- ³⁸ Some reduction of the efficiency of liberal democracy is due to inherent failures. Some of these are discussed in *Nexus: Failures*.
- ³⁹ Some counties in Florida used ballots that resemble old computer “punch cards.” A voter used a tool to punch out a spot on the card that represented her or his vote. However, if the punch tool did not completely remove the area punched out, the result was a “hanging chad” still stuck to the back of the ballot card. Hanging chads sometimes resulted in the computer card reader making an error in reading the ballot.
- ⁴⁰ For other reasons liberal democracies might fail to be efficient. See *Nexus: Market and Government Failures*
- ⁴¹ http://www.idea.int/vt/survey/voter_turnout_pop2.cfm accessed on May 2, 2002. Percentages reflect averages participation from 1945-1998.
- ⁴² *Ibid.*
- ⁴³ This statement was used as a motto on the title page of *An Historical Review of the Constitution and Government of Pennsylvania (1759)*, written by Franklin. See http://en.wikiquote.org/wiki/Benjamin_Franklin for full attribution.
- ⁴⁴ John Locke, *Second Treatise on Government* (1690), accessed on August 24, 2005 at <http://jim.com/2ndtreat.htm>.
- ⁴⁵ James Madison, *The Federalist No. 51: The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments*, accessed on August 24, 2005 at <http://www.constitution.org/fed/federa51.htm>.
- ⁴⁶ John Rawls, *A Theory of Justice* (1971), 152-157.
- ⁴⁷ For more about efficiency, see *Nexus: Efficiency*.
- ⁴⁸ Arthur Okun, *Equality and Efficiency: The Big tradeoff*. Washington, DC: Brookings Institute.
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- ⁵¹ *Preamble, United States Constitution*.
- ⁵² West’s Encyclopedia of American Law (West Group: St. Paul, MN, 1998)
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- ⁵⁴ Cargill, Thomas F. and Mayer, Thomas. *The Great Depression and History Textbooks*. Foundation for Teaching Economics. Retrieved on April 14, 2003 from: <http://www.fte.org/teachers/readings.htm>
- ⁵⁵ However, note that depository insurance schemes create another problem, which economists call “moral hazard.” Basically, deposit insurance relieves depositors of the need to scrutinize the lending practices of the banks. This was the essence of the problem in the American “savings and loan crisis,” which cost the treasury \$165 billion. It is also a large problem for other countries. See “Disruptions in Global Financial Markets: The Role of Public Policy” by Michael Moskow accessed in the third quarter, 2000 issue at: <http://www.chicagofed.org/publications/economicperspectives/>
- ⁵⁶ For a readable treatment of monetary policy, see the Webpage of the Federal Reserve Bank of New York: <http://www.ny.frb.org/pi-home/addpub/omo.html>
- ⁵⁷ However, not all nations insulate their central bank from political pressure by making it “independent.” In the United States, the FED is, by law, independent from both the three branches of government in conducting its policies. There is evidence that central banks so insulated achieve better price stability.
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- ⁵⁹ See *Nexus: Efficiency*
- ⁶⁰ The term *public good* refers to both goods and services.
- ⁶¹ ‘Free-riders’ are individuals who are able to enjoy the benefit associated with a good without paying for it. For example, individuals who avoid paying (whether legally or illegally) federal taxes, still receive the benefits of national defense or interstate highways.
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- ⁷⁶ See *Nexus: Market and Government Failures*.
- ⁷⁷ The case is extremely complicated with some plaintiffs accepting a settlement between the Department of Justice and others sought tougher remedies. See <http://cyber.law.harvard.edu/msdoj/> for wonderful resources and a timeline.
- ⁷⁸ See *Nexus: Market and Government Failures*.
- ⁷⁹ World Trade Organization: Selected Long Term Trends. Accessed at http://www.wto.org/english/res_e/its2002_e/itso2_longterm_e.html on May 2, 2004.
- ⁸⁰ For example, China’s merchandise trade increased 40% in 2003 and one of the most dynamic trading regions in the last few years has been post-Soviet bloc countries. See “World Trade Picks Up Speed.” BBC News, April 5, 2004. Accessed at <http://news.bbc.co.uk/1/hi/business/3601757.stm> on May 14, 2004.
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- ⁸² Adam Smith. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Amherst, NY: Prometheus Books, 1991, p. 422).
- ⁸³ The theory is usually attributed to David Ricardo who described it *The Principles of Political Economy and Taxation* (1817) in an example involving England and Portugal.
- ⁸⁴ Buchholz, Todd G., *New Ideas from Dead Economists*, (New York: Penguin Putnam, Inc., 1999) p. 71.
- ⁸⁵ See *Nexus: Failures*.
- ⁸⁶ Hufbauer, Gary Clyde, Jeffrey J. Schott, and Kimberly Ann Elliott. *Economic Sanctions Reconsidered*, 2nd edition (Washington: Institute for International Economics, 1990).
- ⁸⁷ See the section on *Market and Government Failures* for a discussion of these ‘spillover’ effects.
- ⁸⁸ Garten, J. (1997, May/June). Business and Foreign Policy. *Foreign Affairs*, pp. 67-79.
- ⁸⁹ James Gwartney and Robert Lawson, eds., *Economic Freedom of the World, 2001* (Vancouver, BC: Fraser Institute)
- ⁹⁰ Johan Norberg, *In Defense of Global Capitalism* (Washington, DC: Cato Institute).
- ⁹¹ Ibid
- ⁹² Robert Dahl, *After the Revolution: Authority in a Good Society* (New Haven, CT: Yale University Press, 1990).

