Lesson 6: How are Capitalism and Economic Freedom related?

Written by Jamie Wagner

In this lesson students will explore the key economic institutions and language of economic freedom including open markets, open trade, rule of law, and property rights.

Description of the lesson

This lesson focuses on defining economic freedom and the economic institutions that make up a capitalistic economic system. Students will explore the key economic institutions and language of economic freedom including open markets, open trade, rule of law, and property rights. The goal of this lesson is to provide the foundation for the language to talk about economic freedom and economic institutions in a constructive way using the economic way of thinking. Additionally, students will think about examples of each economic institution in Canada.

Economics

Economics is the study of choices. The lesson focuses on how the incentives of a country are altered based upon the economic institutions within that country. The prevailing image of a “capitalist” may be a businessman, but a survey of the world’s economies reveals that, like poverty, capitalism has many faces. “Capitalist” is used, in either praise or condemnation, to label many nations, and the label is claimed –whether deservedly or not – by many more. This lesson will frame the term capitalism using the idea of economic freedom and examine how economic institutions affect how choices can be made in different economies. Ultimately, the lesson will provide language for students to be able to analyze how important economic freedom is to improving outcomes for individuals including the poor.

Objectives

After completing this lesson students will be able to:

* define and explain how economic institutions are a measure of economic freedom.
* explain how economic institutions affect incentives within a country.
* compare and contrast examples of different economic institutions in Canada.

Voluntary National Content Standards In Economics

* Standard 4: People respond predictably to positive and negative incentives.
  + Acting as consumers, producers, workers, savers, investors, and citizens, people respond to incentives in order to allocate their scarce resources in ways that provide the highest possible returns to them.
* 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 well-enforced property rights, is essential to a market economy.
  + Property rights, contract enforcement, standards for weights and measures, and liability rules affect incentives for people to produce and exchange goods and services.

Concepts

Economic Systems, Incentives, Institutions

Time Required

45 minutes

Materials Needed

* Slide presentation “Lesson 6: How are Capitalism and Economic Freedom related?”
* Notebook with pen or pencil, or hand out a piece of paper in procedure 7.
* Copies of Assessment 1, one per student or one per group of 2-3 students if you want to do group work.

Procedure

1. Begin the lesson, show slide 2 and ask students what they think it means to be free? *Answers may vary but include being able to do whatever you want, not having someone/government make decisions for you, etc.*
2. Remind or tell students that **economics** is the study of choices and that how economically free a country is country affects the choices that the citizens can make which then has big implications about wealth/poverty, technological advancements, safety, entrepreneurship, and many more outcomes. Use slide 3.
3. Follow this up by showing slide 4 and explaining that economists and organizations such as the Fraser Institute[[1]](#footnote-1) define, measure, and study economic freedom. Define **economic freedom** as the freedom of choice that individuals enjoy in acquiring and using economic goods and resources. The Fraser Institute notes the following about economic freedom: “Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others. Individuals are free to choose, trade, and cooperate with others, and compete as they see fit.”
4. Explain to students that economic institutions are key to defining a country’s economic freedom. Show slide 5 and define for students that **economic institutions** are the established behavior practices and patterns upon which the life of a community is built. Nobel laureate and economic historian Douglass North calls them “the rules of the game.” They are fixtures of people’s interactions with one another.
5. Ask the students what rules they think would make a country economically free? *Answers will vary but may include being able to buy or sell whatever they want, not having someone take their stuff or ideas, the government or whomever is in charge cannot tell you want to do, etc.*
6. Follow this up by explaining that the “rules of the game” or economic institutions can be both formal or informal. Continue by explaining the following:
   1. Formal institutions, like constitutions and statutory law, codify the rules under which the members of the economy interact.
   2. Informal institutions are not necessarily written but they are expectations of behavior. These are at least as important as formal institutions.
   3. Economic historian and Novel Laureate, Douglass North, argues, in fact, that informal institutions may exert even more influence over behavior than formal laws. Laws may have little ability to shape behavior if they do not match up with informal but ingrained cultural and social norms.
   4. Additionally, while formal laws may be changed at any time, informal institutional arrangements tend to be persistent and change very slowly.
7. Ask the students to think about the “rules of the game” or institutions at the school. Have the students work with their neighbor to think and write down 3 formal and 3 informal rules from their school in a notebook or a handed-out piece of paper. After about 3-4 minutes have students share out their answers. *Examples of institutions are on slide 6 and may include the following:*
   1. *Formal institutions: Rules about being late to school/class, rules about excused vs. unexcused absences, rules about fighting or weapons, etc.*
   2. *Informal institutions: speaking kindly to peers, using correct titles for teachers or other staff, legible handwriting for assignments, etc.*
8. Tell the students that each individual class they take is like its own mini economy. Use slide 7 to explain this. You have someone in charge (your teacher), with their guidelines or rules, its own currency (the points or grades you get in that class), and different choices you can make. Now ask students if they sometimes behave differently in different classes because of the rules that are in place in that class (or not). For example, are there teachers that are stricter about being on time, using your phones, food in class, etc.? Your behaviors are altered by the incentives and rules of the classroom.
9. Tell students that economic institutions influence behavior by shaping incentives for countries as well. Then define **incentives** which is on slide 8 as rewards and punishments for behavior. Economists have long recognized that people react to incentives in predictable ways. Continue by explaining that incentives shape many of the choices people make. Incentives explain observable patterns of economic decision-making. It is important to remember that economic institutions do not operate independently and that they are always constrained, to a greater or lesser degree, by political and governmental institutions.
   1. The major economics institutions that we’re going to focus on are the following:
      1. Open Markets
      2. Property Rights
      3. The Rule of Law
      4. Entrepreneurship
   2. Tell students that these operate on a spectrum and that countries all range in how well they protect these institutions or how prevalent these institutions are in the country. Additionally, these institutions act as incentives for how decisions are made and conflicts resolved—either cooperatively and peaceful or non-cooperative and violent.
10. Define each institution for the students and show the definitions on slide 9:
    1. **Open Markets**—Institutions governing voluntary exchange
    2. **Property Rights**—institutions governing the ownership, use and transfer of private property. The definition of property rights includes individuals’ rights to self (labor) and possessions
    3. **The Rule of Law**—the extent and limits of authority and privilege.
    4. **Entrepreneurship**—institutions governing risks and rewards of organizing resources for production.
       1. Note that Entrepreneurship can only exist and thrive when there are open markets, property rights (including the right to your own self), and the rule of law are protected. Without those institutions there is no incentive for entrepreneurship.

Remind students that the characteristics of these institutions vary greatly from country to country. The result is a broad spectrum of economic freedom or “capitalist” practices, some empowering the poor, and some holding them back.

1. Continue by explaining that the underlying assumption of those who favor economic freedom is that individuals know their own needs and desires best and that a self-directed life, guided by one’s own philosophies and priorities rather than those of a government. Use slide 10 to explain the following.
   1. Note that from the Fraser Institute’s perspective and most economists that the goal of economic freedom is not elimination of government but rather, the primary role of government is to protect individuals and their property from aggression by others. Continue by telling students that capitalist economic systems support economic freedom and protect economic institutions.
2. Ask students how changing the institutions can affect the incentives by asking the following questions on slide 11:
   1. What do you think would happen if your school had no rules, but the principal was completely in charge of setting punishments when a student misbehaved? For example, imagine if a student wears a Maple Leafs jersey but the principal hates that team so they expel the student from the school. *Answers may vary but include the principal might show favoritism to certain students and let them get away with things while another student might get punished, the principal might change their rules based on their mood for the day—if they are in a good mood then students might be able to get away with breaking rules, or the principal could make up new rules each day without any reason or justification.*
   2. What would happen if you did not have lockers or people could just take and use whatever books, pens, and other resources that are around the school? *Answers may vary but include that students would be worried about their stuff being stolen, the teachers’ classrooms would be bare because their stuff would be taken and the teachers would not want to buy more things for the classes, the halls could be messy with people going through lockers and backpacks.*
   3. How would you feel if there was only grammar club at school—no sports, band, theater, or other clubs? The only club that was allowed was the grammar club to proofread the local newspaper for fun. If you had an idea for another club, you could ask the principal but they would have to approve it and a new club hasn’t been approved in decades. *Answers may vary but include that students would be bored, upset, or frustrated that something they are interested in*. *If students wanted to start a new club, they were limited and so could not pursue a sport they liked or join something else to help them for their future education/career goals.*
   4. How would you feel going to school—would you feel confident going to school to learn each day? *Answers may vary but students might state that they feel scared, nervous if they are going to get in trouble, worried about their stuff getting stolen, teachers might not want to work there because their stuff is ruined or taken too, etc. There would not be much learning because of the lack of confidence or structure of the school.*
   5. Do you think there would be students who might want to be creative and start a school store that could sell snacks, school logo gear, and school supplies? *Answer: no—the student would face a lot of work to start the store and it’s up to the principal to decide which could be volatile given their mood or their favoritism and the stuff they sell in the store is unlikely to be protected from theft and the student could lose a lot of money.*
3. Explain to students that the institutions change the incentives of the students. There are rules which are clearly defined in the student handbook. The principal enforces the rules, but they are not the sole governing body and they must follow the rule of law rather than their own made up rules. Private property is protected at schools and students can get in trouble (negative incentive) if they steal things from other students or teachers. In schools, there still must be approval for clubs and extra-curricular activities but in general, if a student has an idea for a club, and follows the steps set up to start their club, they have a chance of getting approved. A school store would never survive without the institutions protected like rule of law, property rights, and open markets. And finally, learning would be severely hindered in the above scenario because students are worried about the future, getting in trouble, or keeping an eye on themselves.
4. Provide another analogy for students on slide 12 and explain that looking at nations, institutions are the threads in a nation’s “social fabric.” Like cloth fabrics, a social fabric is constructed of interwoven threads. Cloth threads are cotton, linen, wool, or synthetics; the threads from which a “social fabric” is woven are institutions. This analogy also helps us to explain the variety in capitalist economies. Consider that even cloth fabrics made from only one type of thread may look and feel different. Cotton thread may be spun in different ways – bulky, thin, smooth, or rough – and the resulting cloth has a distinctive look and feel. Similarly, any single capitalist institution (markets, private property, rule of law, or entrepreneurship) may take on various forms, depending on factors such as the culture, government, and history of the nation. Provide students with the following examples:
   1. Markets, for example, differ in the extent of regulation and openness.
      1. At one end of the spectrum are Hong Kong’s virtually unregulated markets, which provide almost all goods and services.
      2. In Western Europe, markets provide most products, but the government provides health care, and many forms of communication and transportation.
      3. At the other end of the spectrum, China’s markets provide few products; they are restricted to agriculture and a few government-selected manufactured goods.
5. Show slide 13 and define for students that an **economic system** is the method of production, resource allocation, and distribution of goods and services within a country or society. The type of economic institutions dictates which type of economic system the country falls under. Follow this up by explaining that capitalism and socialism are the two extremes of different economic systems and that all countries fall within the range somewhere. Use the following definitions for students:
   1. The International Monetary Fund (IMF) and other organizations define **capitalism** as an economy where “capital assets—such as factories, mines, and railroads—can be privately owned and controlled, labor is purchased for money wages, capital gains accrue to private owners, and prices allocate capital and labor between competing uses” (Jahan and Saber Mahmud, 2018).
   2. **Socialism** is an economy where the “…state owns the means of production, and state-owned enterprises seek to maximize social good rather than profits.” (Jahan and Saber Mahmud, 2018).
6. Follow this definition up by asking students why it is important that people or private citizens can own capital assets or sell their time for wages? *Answers may vary but include that a person can earn an income, some might say that owning stuff provides an incentive for taking care of the item or making improvements, others might state that owning their own time allows them to choose what they do with their time.*
7. Continue this discussion by making the connection that countries that are more economically free are more capitalistic and countries that are less economically free (or economically unfree) are more socialist. Use slide 14 and explain the key differences in economic institutions. Economic freedom and economic institutions such as the rule of law, property rights, and markets provide incentives for an individual care or improve things and therefore increase their wealth and standard of living.
8. Next, tell students that historical record shows that the success with which an economy deals with poverty depends on the institutional forms it adopts. Some forms of capitalism have successfully generated economic progress that alleviates poverty. Others have failed to do so. In successful capitalist nations, the institutional threads have the following distinctive characteristics:
   1. Property rights are clearly defined and secured.
   2. The rule of law prevails within a framework of limited government
      1. Note that just having democratic political institutions is not sufficient to satisfy this requirement.
   3. Markets are open and competitive.
      1. Competitive interaction creates an ethic in which individuals’ choices have consequences.
   4. Entrepreneurship is fostered by incentives to invent, innovate and produce.

Closure

1. Close the lesson by asking students the following questions on slide 15 to help gauge how well they can reiterate the definitions from the lesson:
   1. What are the key economic institutions that are general characteristics of economic freedom? *Answer: Open Markets, Property rights, Rule of Law, and Entrepreneurship*
   2. What are incentives? *Answer: Rewards and punishments for behavior.*
   3. How do economic institutions affect the incentives within a country? Answers may vary but include: *Economic freedom and economic institutions such as the rule of law, property rights, and markets provide incentives for an individual care or improve things and therefore increase their wealth and standard of living.*
2. Show slide 16 and explain that economic freedom and economic institutions are the key to the incentives that people experience. The economic institutions shape incentives and the ability for people to make decisions about their resources including land, labor, capital, and entrepreneurial ability.
3. Tell students that understanding the key language in this lesson is important to understanding other effects of Economic Freedom. There are many implications and correlations between more Economic Freedom and other metrics of positive economic outcomes including economic growth, poverty reduction, income (including income of those in poverty), and others which we’ll explore next using data from the Fraser Institutes’ Freedom of the World index.
4. Next hand out the Assessment for students to complete either on their own or in groups of 2-3. The students need to think about Canada specifically as they are completing the assessment.

Assessment 1

Fill out the following Tables

1. In the space below define in your own words each economic institution.

|  |  |
| --- | --- |
| **Institution** | **Definition** |
| Open Markets |  |
| Property Rights |  |
| The Rule of Law |  |
| Entrepreneurship |  |

1. In the space provided provide an example of each focusing on Canada. In the last column score Canada on how well (or not well) the economic institutions is protected or supported with 0 being the lowest or does not protect that institution at all to 10 being they perfectly protect that institution.

|  |  |  |
| --- | --- | --- |
| **Institution** | **Canadian Example** | **Score (0-10)** |
| Open Markets |  |  |
| Property Rights |  |  |
| The Rule of Law |  |  |
| Entrepreneurship |  |  |

1. Explain briefly why you ranked the institutions the way you did for Canada. Use proper writing techniques including grammar and punctuation.

References

Jahan, S., & Saber Mahmud, A. (2018, May 10). *What is capitalism?*. IMF. https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Capitalism

1. <https://www.fraserinstitute.org/> [↑](#footnote-ref-1)