

## Teaching the Benefits of Capitalism

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Roger B. Butters, Ph.D.

President, Nebraska Council on Economic Education

Assistant Professor of Economics

University of Nebraska – Lincoln

339 College of Business Administration

Lincoln, NE 68588-0404

Tel: 402.472.2333

Fax: 402.472.9700

[rbutters3@unl.edu](mailto:rbutters3@unl.edu)

## I. A Place to Begin

"The history of capitalism is a history of slavery, child labor, war, and environmental pollution."

The social climate regarding capitalism is so thoroughly charged that even in a university setting suggesting a course designed to teach students about capitalism, much less about the benefits associated with capitalism would, in most quarters, be met with outright hostility. This hostility is largely due to the way that our culture perceives, or misperceives, capitalism. This is unsurprising. In the popular press, textbooks and social commentary the word capitalism is used to describe and explain the absolute worst in human nature. The African slave trade, the Great Depression, the decimation of Central America, the genocide of the Native American, Enron, inside dealing, corruption and human misery are all laid at the doorstep of this thing called capitalism.

The irony of the cultural perception of capitalism is not lost on those who study it. Corruption, greed, selfishness, the disregard for human life and every other negative human trait exists independent of the social structure in which people live. The great irony is that capitalism restrains and curbs these traits and provides the foundation for a peaceful, prosperous and just society for all mankind. Capitalism creates an environment in which the human spirit can achieve and excel. The challenge to educators is to lead students past the pop-culture perceptions and definitions to an accurate understanding of what capitalism is and where it can take us.

The best strategy for teaching about capitalism follows Bastiat by helping students see the unseen. Put another way, in teaching the benefits of capitalism we must help our students transition from merely seeing what passes before them to observing the world around them. Students must learn that slavery, child labor, war and pollution occur in every kind of society and in every period of history but that some forms of social organization encourage these things and some forms of social organization discourage them.

The task of an educator trying to teach the benefits of capitalism is challenging to say the least. In order to be successful, the educator must be willing to place capitalism in its historical context so students can escape their own chrono-centrism and understand how large sections of the human race, for the first time in history, have been able to escape the poverty that was and is the standard, normal condition of the human race.

Students of a teacher willing to carefully develop and explain the origins and functions of capitalism will be rewarded to learn that not only is Mr. Cohen's statement patently wrong, but that capitalism forbids slavery, eliminates child labor, discourages war and actually promotes conservation and preservation of the environment and scarce resources.

## II. A Brief History of the World

“the life of man, solitary, poor, nasty, brutish, and short”

—Thomas Hobbes

When Thomas Hobbes made his now famous statement that the life of man was solitary, poor, nasty, brutish, and short he could not have been more correct. Indeed, the same pronouncement at any time in the previous 7,000 years of human history would have been accurate. Hobbes lived in a world of abject, grinding poverty, limited human rights, and stagnant societies. It is true that there had been several bright spots for the human race but these were generally short-lived and quickly forgotten. And even the bright spots really only served to shine light on the wretched state of the majority of mankind. Hobbes could reflect on Classical Greece or the rise of Egypt or even reflect on the rise of Rome or the more recent voyages of the Spanish and Portuguese. He may or may not have known about the rise of the Chinese Empire and the great voyages of discovery that occurred from Asia to Africa and even the Americas. But he clearly understood that although small groups or classes of individuals had been able to escape poverty, the majority of mankind throughout history could only hope for a life of toil, sickness, privation and death.

Hobbes’s statement, although an accurate reflection of the past and present, was ill timed. As he spoke dramatic changes in the fabric of human existence were taking place. In the fourteenth century the Black Death left Europe with abundant amounts of capital and land and very few laborers to use it. With more resources per person, real wages and standards of living began to rise. As the real wage of labor rose, the traditional Lord-Serf relationship was broken. Serfs began to acquire and improve property instead of simply farming it as tenants. As incomes and property ownership rose among the masses they began to demand improved property law and enforcement mechanisms. Along with rising wealth, cities began to grow and commerce began to flourish. With the advent of increased commerce and the entrepreneurial class, societies increasingly shifted to money-based transactions and away from traditional barter which made increased specialization in production possible.

A little more than a hundred years after Hobbes, Adam Smith found himself sitting in Scotland amazed at the changes he was observing around him and throughout England. Put simply, people were getting rich and it was not just the connected or social elites that were getting rich, the commoner was becoming wealthy too.

What Adam Smith was seeing was unprecedented in human history. Sustained economic growth was reshaping the old world and driving innovation in the new. For those countries that were able to begin and sustain growth entire populations rose above the historical norm of poverty and entered an age of wealth and prosperity.

What drove this great sea change in human events? Some think of it as an Industrial Revolution where the rise of the machine increased productivity enabling higher standards of living. In general that view is correct. It would be more correct, however, to speak of a social revolution that preceded and enabled

the Industrial Revolution. The raw materials for machines, innovation, invention, markets and commerce have always existed. What made it possible for them to be combined together in the Industrial Revolution was the arrival of a new set of social institutions I'll call the Capitalist Revolution.

### III. What is Capitalism?

Capitalism

Main Entry: cap-i-tal-ism

Pronunciation: 'ka-p&-t&-"liz-&m, 'kap-t&-, Brit also k&-'pi-t&-

Function: noun

: an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market.

The standard dictionary definition of capitalism is not only inadequate but also wrong and is most likely the proximate source of the confusion associated with capitalism. This is true for the simple fact that, by its definition, capitalism does not exist and cannot exist. It, like so many other things in our educational system, is design to fit nicely into a discrete box that can be memorized and then recognized on a multiple choice exam. It does not reflect the world in which we actually live and like other “economic systems”-based education for understanding socialism, communism and fascism, it provides no real value to students in understanding the world.

Consider for example the United States, a country with a “Capitalist” economic system. Within the United States many capital goods (roads, communications networks, ports, bridges, rail systems, etc.) are not privately or corporately owned but are instead owned and operated by the public sector and funded through taxation. Consider China or the former Soviet Union, classical examples of a “Communist” economic system. Within the Soviet Union farmers were permitted small private plots for growing vegetables and other produce, individuals could own cars and trucks. In China private ownership of capital goods has always existed as it did in the Soviet Union with private ownership of equipment machinery and tools. None of these real world examples nicely encapsulate themselves into the discrete definitions that drive the “economic system” approach in education.

In order to teach the benefits of capitalism, or any other “system” for that matter, we require more robust and realistic definitions. We must recognize that the heart of capitalism is the private ownership of property and the heart of communism (at the other end of the spectrum) is the public ownership of property. Countries and states exist along a continuum between the two endpoints, not clustered at one end or another. The extent to which a country is capitalistic is determined by the extent to which the social institutions of the country promote and facilitate the private ownership of property. As such

some countries will be more capitalistic than others. No country will ever be purely capitalistic and no country will ever be completely devoid of capitalism.

This creates the unfortunate consequence that teaching students about capitalism requires educators to expand their teaching beyond canned definitions and memorized statements. They must instead engage their students in a discussion of what capitalism is and how it manifests itself. Only then can a student place a society on the continuum of capitalism. Only then will the benefits that capitalism affords become obvious to a student who is now trained to observe the world around them instead of merely seeing what they are shown.

#### **IV. A Robust Definition**

Douglas North, Nobel Prize winner in economics and economic historian, defines capitalism as the presence of four key social institutions. Social institutions are nothing more than the formal and informal rules of the game that shape the decisions made by individuals and societies. The importance of the rules of the game cannot be understated. Even small changes in the rules that govern a society can create dramatic and sometimes un-intuitive changes in the behavior of its citizens.

Examples of how the rules of the game impact outcomes abound: The addition of a “second highest bidder pays” rule to a standard auction will result in a dollar bill being sold for more than a dollar. Aggressively enforced environmental laws lead private land owners to clear-cut trees and shrubbery. Requiring citizens to return a burnt out light bulb to obtain a new one results in a black market for burnt out bulbs and a shortage of bulbs in public buildings. Implementing quotas on sugar imports leads people to import cake mixes, refine out the sugar and discard the remaining ingredients. The list is endless. At the end of the day people respond in predictable ways to the incentives they face and the institutions a society embraces structure the incentives.

For Douglas North the institutions that define capitalism are private property rights, the rule of law, competitive markets, and entrepreneurial behavior.

Following North I define private property rights as the ability of an individual or collection of individuals to possess, use, transfer or dispose of something that is owned. That thing may be a physical asset such as land, a house, a bicycle, a frying pan or any other item lawfully acquired through voluntary exchange. Or it may be more intangible property such as an individual’s self; his labor, thoughts, feelings, and beliefs. Finally, it extends to things which have not yet been created, or even thought of, that may exist in the future. Private property rights are THE Rule of the Game in capitalism. The ability to own and transfer property is the very core of capitalism and is the necessary condition for all the benefits that subsequently flow from adopting the institutions of capitalism.

Property rights, however, are not a sufficient condition. In order for the rules of the game have any real meaning they must be defined and enforced: The same is true for property rights. Societies must

define the terms under which something may be owned, used or transferred. The definitions are necessary to prevent one individual from improperly infringing on the property rights of another. For example, should the owner of a plot of land in an agricultural area be allowed to utilize it as a dumping ground for toxic waste? The definition of his right matters because the choice to dump waste will have significant external impacts on neighboring property holders.

How society chooses to define the right is less important than the need for the definition. When rights are clearly defined then social interaction is smooth and consistent because expectations are set, understood and predictable. If you've ever watched a sporting event, the importance of defining the rules is natural and obvious: Without clearly defined rules the game quickly degenerates into chaos. Some societies will choose to strictly define property rights with strong emphasis on the rights of the owner while others will choose to place emphasis on the external impacts of the choices a property holder might make. So, just as capitalism exists along a continuum so does the character of property rights within a country.

Simply defining the right to property is also not enough; societies must enforce those rights. Property rights that are defined but unenforced are useless and serve no purpose. Consider the Dalit, or Untouchables, of India. Under the Indian Constitution the Dalit are guaranteed all the rights and privileges afforded every other citizen. The reality is quite different. Due to their social status, the Dalit are considered the lowest caste of society and generally are confined to the most menial jobs and their constitutionally guaranteed rights are generally unenforced. As a result, the constitution has little meaning to the Dalit and they are consistently deprived of their rights. Just as a sporting event requires a referee, property rights require an enforcer.

Historically, the enforcement of the rules of the game in a society have fallen into three broad categories: The Rule of Force—social rules and enforcement are determined by the use of violence; The Rule of Men—where rules are enforced at the whim of the enforcer; and The Rule of Law—a legal structure where laws are clearly defined and the government is subject to the same laws as the governed.

Each of these can be easily placed in context by a quick review of the Arthurian Legend. Faced with a the need to rule a kingdom, Arthur rejects the axiom of "Might Makes Right" (The Rule of Force) and instead adopts a Round Table which promulgates laws to which everyone in the realm is subject. Having established the Rule of Law, Arthur is faced with a dilemma due to the adultery of Guinevere and Lancelot. He must either maintain the Rule of Law by executing his closest friend and his wife (laws apply to the government as well as the governed) or abandon the ideals of the Round Table by pardoning his friend and wife and allow the legal structure to degenerate into the Rule of Men (the rules are enforced at the whim of the enforcer).

For the purposes of teaching capitalism it is important for students to realize that like capitalism itself, and property rights, the enforcement of the rules of the game also falls along a continuum ranging from

pure anarchy to the absolute rule of law. There are no discrete boxes in which to place societies, only degrees by which they reflect the social institution.

The third institution of capitalism is the presence of competitive markets where goods and services are produced and exchanged. By competitive we mean that individuals are free to enter and exit a market at will. To a large extent the rules of the game will influence the ability of individuals to enter and exit the marketplace. Licensing requirements, taxation, regulatory burdens, compliance issues, the availability of credit, and even the extent to which property rights are secure will all jointly determine how competitive markets develop in a society.

The fourth institution is the promotion of entrepreneurial activity. An entrepreneur is someone that assumes risk in organizing land, labor, capital and technology to produce a new product, or to compete in a marketplace with existing producers. Like we have seen with competitive markets, whether or not a society will produce entrepreneurs is very much a function of property rights and the rule of law. In order for a person to be willing to assume risk they must have the reasonable expectation that the potential profit associated with the risk offsets the potential costs.

Seen in general terms, property rights are the genesis of capitalism, the rule of law the enabler, and competition and entrepreneurial activity the consequences. Property rights that are defined and secure will naturally result in the formation of competitive markets. They will also lead to the advent of entrepreneurs as individuals who are secure in their possessions seek to better their own lives as well as those people they care about. Ultimately it is not governments, countries or corporations that determine how a society is shaped, how wealth is created or destroyed, or the condition of the people they represent. Ultimately, the character of the world is shaped and molded by individuals making choices based on the incentives they face and the goals they seek to achieve. Property rights, the rule of law, competitive markets and entrepreneurial activity represent a collection of social institutions that shape the incentives people face and the choices they make.

## **V. What are the benefits of Capitalism?**

The single greatest benefit that capitalism provides is that it enables human choice. Capitalism establishes a social contract that makes it possible for individuals to exercise their franchise and free agency. It gives people the ability to be secure in themselves and their possessions and, having provided security, it enables people to assume risk that they were previously unwilling to assume. It creates the necessary conditions for people to escape poverty and create wealth for themselves and for others.

Consider, for example, property rights that are clearly defined and enforced under the rule of law. As a practical matter this provides the poor and dispossessed a resource and tool that has always been available to the wealthy and powerful. Local Lords and Kings rarely worry about their lands and possessions being seized because they have the resources and ability to defend their right to property on their own. The common poor serf has no such luck. When we define the rights of the poor as well as

the rich, and provide an impartial mechanism for enforcing those rights, suddenly the poor man is on equal footing with the rich in matters of security.

It is unsurprising that advocates of capitalism were also some of the first groups to oppose the institution of human slavery. Economics did not receive its nickname of the “dismal science” because of the predictions of Malthus but instead earned it as an epithet from Thomas Carlyle, an advocate of the slave trade and proponent of forcibly compelling freed slaves to work for sub-standard wages. The nickname has its origins in a debate with John Stuart Mill in *Fraser’s Magazine* in the late 1800’s regarding the economist’s belief that men should not be compelled to labor, that markets should determine wages and that white and black men should receive the market wage. Carlyle felt that a social science which placed white men and black men on the same footing “is a dreary, desolate, and indeed quite abject and distressing one; what we might call ... [a] dismal science.”<sup>1</sup>

Slavery, abuse, murder, and any other crime against a person is ultimately a violation of the right they have to security in themselves and their property. It is unsurprising that capitalist societies tend to be free societies where men and women of various races all enjoy a similar franchise. Capitalism ennobles the human spirit by protecting the individual from competitive violence and coercive force. It provides the structure for people to pursue their best interests. The concept of human rights has evolved in tandem with the concept of property rights. Being able to understand the ownership of a thing is straightforward due to the tangible nature of property. Once a society can develop the rights to something tangible it can progress to developing rights for intangibles. The intangible rights of life, liberty and the pursuit of happiness are the natural outgrowth of understanding the universal right to security in one’s possessions, person and thoughts. Indeed, property rights are the only human rights because if we can arbitrarily deprive an individual of her possessions we can deprive her of everything else. It is interesting to note that intellectual property rights are not recognized in nations where private property is insecure. Tangible property must be secure before people can understand the need to secure intangible property.

Property rights create incentives that encourage people to consider the future. When people own something their welfare is inextricably tied to that thing. As a result there are incentives to preserve, protect and improve their property. No one would ever think of checking the oil in a rental car much less buying a quart and topping it off. However car owners regularly check the oil, wiper fluid, transmission fluid and radiator. Why are the behaviors different? Property rights. With ownership comes the ability to use and transfer. By taking steps to preserve property the owner increases his standard of living either through extended use, greater utility in use, or through the increased residual value at the time of sale or transfer.

Property rights encourage people to protect and improve property for the same reasons they preserve it. By protecting property from damage a person becomes wealthier, by improving the property he may

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<sup>1</sup> *Fraser’s Magazine*, Volume 11, p 177.



enjoy it more today and receive greater value for it in the future. In every case the incentive works to create wealth for the owner of the property.

Now it is true that simple ownership does not guarantee preservation, protection or improvement for any single individual. The institution provides a social incentive but as with any incentive individual variation exists as to how people will respond.

The creation of new wealth is the phenomenon that Adam Smith observed and explained in the *Wealth of Nations* and is a process that continues today. However, in order for this sustained economic growth to occur there must be sustained investment and capital formation. Investment requires an individual to reduce consumption today in the expectation of higher consumption in the future whether that be the decision to plant a crop, tend an orchard, build a fence, create an irrigation system, build a new factory, or invent something completely new. Property rights create the security that makes risky capital formation possible. Research conducted in the Amazon basin has demonstrated that this is the case. Farmers with clear titles to their lands engage in capital formation and property improvement with greater intensity than those without clear title. It is clear in Zimbabwe where the dissolution of property rights has removed even the incentive to plant a crop.

Property rights create the incentive needed to conserve scarce resources. Why is the air outside polluted and the air in your car clean? The answer is property rights. You don't own the air outside your car so you gladly pollute it whereas the air inside your car, over which you have a property right, is jealously maintained with air-conditioning, filters and air fresheners. How can we solve the pollution problem? Simple, establish a property right and require that all exhaust fumes be vented inside the vehicle that creates them. Suddenly the incentive to use better fuels, drive a more efficient vehicle and reduce emissions would result in booming innovation in pollution abatement; all in response to a property right. Clearly this example pushes into the absurd, but it illustrates the point none-the-less. For a more practical comparison consider why private bathrooms are clean, and public ones are not. Better yet, why are Maine Lobsters plentiful and orange roughy aren't? – Property rights.

Why are cows thriving and tigers vanishing? Property rights. For cows people have a direct incentive to preserve, protect and improve. For tigers the only incentive is to use the resource before someone else does. Why are elephants and other endangered species on the rebound in some African countries? Property rights. By letting villages own the animals they have an incentive to preserve, protect and improve, and as a result the animals are thriving. Rather than calling poachers when a rhinoceros decimates your corn field, you care for the animal, make sure it has several young and then auction the right to shoot it to a wealthy game hunter. The animals are preserved, the population is maintained, the village receives increased wealth and a private individual has a unique experience. By defining the property right we have gone from extinction and poverty to trade and wealth and at the end of the day there are more, not fewer rhinoceroses.

The tragedy of the commons is one of the most valuable and pervasive examples of what happens when property rights are poorly defined and unenforced. What is the benefit of capitalism? It provides us

with property rights that create the incentives to preserve, protect and improve. It is not surprising that the greatest ecological disasters have all occurred in societies without strong social institutions that protect property.

What are some other benefits? Consider for example peace. In a world of property rights that are defined and enforced via the rule of law there is a strong incentive to reduce and eliminate competitive violence. In a capitalist society the only aggression that is permissible is defensive. Wars of aggression cannot occur because capitalism permits the acquisition of property via voluntary trade and voluntary trade alone.

Beyond providing a consistent set of rules for society the existence of the rule of law provides a great equalization between the poor and the rich, the powerful and the weak. In its perfect incarnation a poor beggar, having been wronged by a wealthy government official, would be able to receive redress through the judicial system. When everyone knows that the rules of the game are being fairly, impartially and properly enforced people are more willing to participate and more accepting when events turn against them. When there is a perception of partiality on the part of the Umpire social interaction quickly degenerates into chaos. In a society comprised of many diverse cultures, races and ethnic groups the rule of law serves as the common cultural norm that allows very different people from very different backgrounds trust one another and work together.

Generally when we think of competition we think of sports where one team or person will win and one will lose. As a result our cultural perception of competition drives us to think of it in terms of a zero sum game or winners and losers. The key to understanding the difference between the type of competition that occurs in a sporting event and the type that occurs in the marketplace is to understand that in sports we compete *for* something whereas in the marketplace we compete *in* something. Anytime people compete *for* something that thing will become more valuable and importantly more scarce. When competition occurs *in* something things become less expensive and more plentiful. Markets and capitalism encourages competition *in* not competition *for*. Which makes competitive trade win-win instead of win-lose.

Consider the competition *for* an Olympic Medal. If you were to ask an athlete which was more scarce, which was more valuable a gold, silver or bronze medal they would naturally respond that the gold medals were the most scarce, the most valuable. This is an odd comment given that the exact same number of medals is presented in each sport. What makes the gold medal more scarce than the bronze is that people compete *for* the gold more than they compete *for* the bronze. As a result the gold medal becomes more scarce and the number of high quality athletes rises as competition *in* the Olympics expands.

In markets, suppliers compete *in* the marketplace, not *for* it. As a result, the exact opposite occurs. In order to successfully compete, the supplier must make a product that is of higher quality, lower price, or more desirable than his competitor. The competitor faced with similar incentives also competes on price, quality, and desirability. The effect is a reduction in the scarcity of goods and services. Lower prices, higher quality, greater diversity all result from fostering competition.

A side note to this discussion is that suppliers compete *for* profits and as in the sports example, competition *for* profits makes them more scarce.

The miracle of market competition is that not only does it reduce material scarcity it creates wealth for every participant. Both the buyer and seller are wealthier for having participated: The seller for having sold something for more than the opportunity cost of production, the buyer for having acquired something for less than the value it imparts.

Entrepreneurial activity, the second consequence of capitalism, is inextricably connected to competition. In competitive markets the only way to accrue wealth to oneself is by creating and providing a product that others value. Furthermore, you must create and provide that product at a cost that is less than the value perceived by your customer. In order to capture a profit the entrepreneur must create something newer, better, cheaper or more appealing. He must find a way to induce someone to voluntarily surrender value to him and to do that he must create value himself. The creative process is risky and as a result people will only assume risk if the expected reward exceeds the expected costs.

Property rights, via a patent or copyright, guarantee that if the entrepreneur creates something of value he will be able to capture, and retain, the profits from its sale. Without that guarantee, entrepreneurial activity slows and innovation and invention cease. The former Soviet Union created some of the greatest minds in the world and yet little or no invention and innovation occurred. The reason why is simple; there was no incentive to do so. Since the scientists had no right to their creation, since businessmen stood to earn no profits, and since entrepreneurs would never be allowed to compete in the marketplace no innovation occurred.

The institutions of capitalism, on the other hand, conspire to find new and better ways to do everything in an effort to impart a fractional advantage when competing in the market place.

There is a reason J.K. Rowling wrote Harry Potter: Capitalism. Rowling lived in a society that defines and enforces property rights, promulgates the rule of law, relies on competitive markets and fosters entrepreneurial activity. All these together created the incentive for an out of work, single mother to sit down in a café and record her thoughts knowing full well that if she created something of value that value would accrue to her and enable her to provide for herself and her loved ones.

Those incentives made a poor woman into the richest woman in the world and a celebrated author that enriched and created wealth for millions of readers throughout the world. It is fitting contrast to the traditional Bogeymen of capitalism; wealthy elites unconcerned with the plight of the poor. Texts and manuals are replete with political cartoons from the 1920s illustrating fat cats smoking rolled money, giant octopi stretching over the land to lay claim to everything or, more offensively, the huddled masses begging for the drippings and scraps from the table of the rich. The reality, again, is exactly the opposite. In a market-based society, where property is secure it is impossible to amass wealth without creating wealth for everyone else.

What are the benefits of capitalism? In short capitalism enables and fosters the sovereignty of human choice. By enabling the individual to act for himself and be the residual claimant for the benefits and costs of those actions, capitalism fosters economic growth, eliminates poverty, fosters human dignity, conserves scarce resources, stimulates innovation and fosters invention.

To be sure, bad people exist. And without question those people seek to oppress, enslave and eliminate the agency of their fellow human beings. The extent to which they will succeed is determined uniquely by the social institutions that shape the societies in which they live. Capitalism, by guaranteeing an individual's security in his property, self, thoughts and beliefs creates incentives that make the success of evil people less likely and their actions less damaging while enabling the individual to succeed.

## VI. Counterarguments

A common response to the traditional presentation of economic growth beginning with the Industrial Revolution and resulting from capitalism is that it is a Euro-centric interpretation of history, and that the wealth was not so much created as transferred as large colonial powers harvested resources and labor without regard to the welfare of the indigenous populations. This follows the basic "divided pie" explanation of production and distribution where it is assumed that there are a fixed number of resources producing a fixed level of output; if one individual or group is wealthier than another, it is because they were able to carve out a larger slice of the fixed pie to the detriment of others. This interpretation of how wealth is created completely ignores the advances in productive capacity brought on by competitive markets and innovation. It assumes a statist view and has driven the popular panics surrounding resources since the time of Malthus.

More damagingly, it ignores basic data and presents a barrier to understanding the nature of modern economic growth. Simply put, Africa is poor not because Europe is rich, but because Africa has always been poor and because Europe adopted a recipe for creating wealth.

Another problem with the "colonial exploitation" view of economic growth is that it fails to explain the experiences of the United States (a colony), Australia (a penal colony), or Hong Kong (a colony), to mention a few. A better explanation is that the colonial masters brought with them social institutions that laid the foundations for sustained economic growth. Within-country examples also abound.

It is important to remember that every country mentioned in this paper was a third world country in 1600. Modern, developed countries did not become rich by making others poor; they merely adopted social institutions that promoted growth and were subsequently able to abandon the impoverished norm of human existence.

A second response to the explanations of economic growth invariably revolves around the availability of natural resources that can be used in the productive process. Many textbooks point to the vast natural resources made available to the United States in its western expansion or the wholesale import of resources from colonies and foreign possessions. As with other explanations this one can also be

abandoned. Indeed, in many respects the presence of vast natural resources seems to be a hindrance to sustained growth, not a benefit.

Consider for example Hong Kong. Hong Kong is a nation with few if any natural resources and yet it commands a strong presence on the world stage as a developed country (now a Special Administrative Region of China). As a British colony, Hong Kong was provided with strong social institutions, property rights were defined and enforced, the rule of law was established, competition was fostered and unfettered, entrepreneurs were encouraged and as a result Hong Kong diverged dramatically from the Peoples' Republic of China: All without the benefit of natural resources. Indeed, Hong Kong's wealth was the result of trade in the single natural resource it had—its social institutions. Further examples include Singapore, Japan, Luxemburg and Switzerland.

Likewise consider the many countries that possess tremendous natural wealth but are unable to develop economically. Poorly defined property rights, the lack of a functional legal system or the centralized ownership of the resources by the public sector are the obvious culprits. When natural resources that can be sold as commodities are owned solely by the government, there is little incentive to consider the needs of the people.

### **Causation versus Correlation**

A final challenge to the capitalist institution-based explanation for the escape from historical poverty is that of correlation versus causation. It is clear from the data that wealthy countries are characterized by the institutions of capitalism; they have clearly defined laws and well functioning legal systems, they define and enforce private property, they use competitive markets to produce and distribute goods and services and they promote entrepreneurial activity. However, one could argue that these institutions are the result of wealth, not its cause. Maybe only wealthy countries can afford property rights and competitive markets. The data cannot distinguish if that relationship exists. In order to establish causality we must be able to perform an experiment where we introduce these institutions into a society and observe the results. A counter experiment is similarly important: Does eliminating the institutions of capitalism eliminate growth and create poverty?

## **VII. Natural Experiments**

Fortunately for educators several such natural experiments exist. Following World War II the Communist Party in the People's Republic of China abolished most forms of private property and eliminated the rule of law. Competitive markets were outlawed and without the profit incentive, entrepreneurial activity ground to a halt. Through the 1950s and 1960s the standard of living for the average Chinese citizen actually fell to levels below those that existed during the Ming Dynasty and programs such as the Cultural Revolution and the Great Leap Forward destroyed human and physical capital throughout the country.

After Mao Zedong's death things began to change for China. Observing the growing prosperity of ethnic Chinese residing in the Pacific Rim outside China, Deng Xiaoping rightly concluded that if Chinese could create wealth outside China they could create it within China. Deng chose to adopt policies of wealth instead of policies of poverty and began a slow, methodical process of introducing the institutions of capitalism into Chinese society. First came trade with other countries, laws regarding investment were relaxed, rudimentary private property laws were developed, competition was permitted and entrepreneurs were encouraged to deliver Chinese goods and services to the world. In the short span of thirty years the standard of living of the average Chinese citizen increased over eightfold and China became an economic powerhouse. Today the reforms and changes continue apace and capitalism is finding its natural extensions into personal freedoms and human rights. True China continues to face difficulties with its transition, just like any other emerging economy, but the lives of the average Chinese are markedly improved and continue to improve.

In 1992 India was on the verge of bankruptcy. The national policy of self sufficiency had reduced the annual growth rate to zero. India had mortgaged its gold deposits and faced ruin in financial markets. The Finance Minister, Manmohan Singh, made the push to liberalize markets, open competition, reduce regulatory burdens and secure private property. The end results speak for themselves. In a short fourteen years India has transformed itself from a poverty-stricken backwater to a vibrant society providing goods and services worldwide. As rural titling programs proceed and as the rule of law is simplified and regularized the poor of India are finding new opportunity and a new future.

The most interesting fact about these two examples is that the leaders of the respective countries made a conscious decision to adopt the institutions of capitalism (we can identify dates and times) and in the course of a few years have risen to the point of being perceived as a threat to established developed countries.

This single best example of how the institutions of capitalism impact a society can be seen with the naked eye from space. Even at night when seen from space the outline and shape of the continents that comprise our planet can be clearly identified. Glowing clusters of lights call attention to cities, towns and even transportation routes. Without any prior knowledge and judging from lights alone a person could easily identify the centers of commerce and wealth on our planet. Without any prior knowledge and judging from lights alone a person could easily identify that something has gone terribly wrong on the Korean Peninsula.

South Korea is ablaze with light and matches the brilliance of Japan just a few miles away. Seoul is easily identified. Ports and transportation hubs can be picked out. Even from space South Korea is obviously a wealthy country with much to offer. Paradoxically, just north of Seoul Korea, the lights end and the land is black. It is as if a great plague or poison has made the land uninhabitable and wasted. Unfortunately, that is not far from the truth.

Following World War II, North and South Korea, as we know them today, were a single country with a uniform population, shared history, common culture and identical standards of living. The paths of these two nations diverged when the institutions of poverty, embraced by China, descended from the

north and the institutions of capitalism were fostered in the south. Without the rule of law, without private property rights, without competitive markets and without entrepreneurial activity, North Korea has become one of the true pariah states in the world. Its citizens live in a perpetual state of starvation and fear and human rights are non-existent.

By contrast over a period of fifty short years the south has become one of the Tigers of Asia with high standards of living, low infant mortality rates, high literacy rate, and endless opportunity.

Switzerland is a particularly interesting case because it not only serves to refute the “Euro-centric” explanation of growth and the resource-based explanation, it serves to demonstrate the causal ordering of economic development like China, India and the Koreans.

At the advent of the nineteenth century Switzerland was a third world country by any reasonable measure. The economic development that was occurring in surrounding European countries was bypassing the Swiss. Things in Switzerland were so bad that laws had been passed to prevent Swiss citizens from leaving the country for the purpose of joining other countries’ armies as mercenaries—things were so bad people were leaving to go and die elsewhere. In 1848 the Swiss established their first Federal Constitution uniting the six cantons into single country with a coherent set of laws. The Constitution was revised and strengthened in 1874 to include consistent rules for defense, trade and common law. More changes were made in 1893 that further strengthened the rule of law and the rights of the people.

The important thing to note for our purposes is that, through the creation of a common rule of law and an uncommonly strong set of private property laws over the course of one hundred years, Switzerland has become one of the richest countries on the planet through trading, to an even greater extent than Hong Kong, their strong social institutions with people who are willing to pay for them. Even tin-pot dictators who would deny their own citizens the right to private property are willing to place their wealth in the hands of the Swiss.

## VII. False Causality – Misguided Intentions

Child workers, most of them girls, were summarily dismissed from the garment factories....Some were found working in more hazardous situations, in unsafe workshops where they were paid less, or in prostitution.

– UNICEF - THE STATE OF THE WORLD’S CHILDREN 1997

Capitalism is usually described with some sort of adjective attached to it. A news story about the appalling conditions of child laborers in a garment, toy or soccer ball factory will inevitably be summed up as the natural result of “unbridled capitalism,” suggesting that capitalism is at its core a force that, through the blind pursuit of profit, reduces mankind, even its children, to the depths of slavery and therefore must be checked. The great irony is that as discussed above the exact contrary is true. For the teacher trying to present the ideas of capitalism these broad-based and pervasive images and social perceptions are extraordinarily difficult to overcome. Students in modern day America grow up in a

world that is completely removed from the issues of absolute poverty. Even for the majority of people they consider poor, poverty includes air-conditioning, washers and dryers, cars, cell phones and ready access to clean water and food. For the nation's poor, obesity is seen as a significant hurdle.

As such students in our classrooms struggle to make the connection that although working long hours for low pay in a garment factory is a terrible use of a child's time, from our standpoint, for the child in question it may be the best of many bad possible uses. Again, here is where making use of data and facts will best serve an educator. Even from sources that are generally opposed to capitalism the data speak volumes. Capitalism is not the reason that a child works long hours in a garment factory, poverty is. The fact that markets and competition have brought the factory job to the child may very well be another example of how capitalism is a mechanism for making poor people rich – especially if the alternative to working in a factory is working as a child prostitute as documented by UNICEF.

The above quote is in reference to the response of garment factories to legislation proposed (but never passed) in the United States that would have imposed trade barriers on manufacturers that used child labor. In response to the legislation thousands of children were dismissed from relatively high paying jobs. When UNICEF followed up on the children they found them in more dangerous jobs, working for lower pay or employed in child prostitution. The feel good policy of reigning in unbridled capitalism literally made prostitutes out of children. Unfortunately examples similar to this one abound.

These discussions must be framed in the historical context of human poverty. A hundred years ago, when the United States was a third world country, children worked long hours at dangerous jobs on family farms and in factories. Although unfortunate, and barbaric by today's standard, it was preferable to starvation.

## IX. The Great Danger of Capitalism

“You can't change the world, but you can change the facts.

When you change the facts you change points of view.

When you change points of view then you may change a vote.

And when you change a vote you may change the world.”

– Depeche Mode

The greatest triumph of capitalism is that it enables human choice. It establishes the Sovereignty of Human Choice as the principle upon which societies are founded and grow. It provides mechanisms through property rights and the rule of law to ensure that the sovereign choices of one individual do not improperly impinge on the ability of another to exercise her sovereign franchise. In achieving this feat, capitalism creates a social structure that ennoble the human spirit, encourages innovation, and feeds physical needs.

At current rates of growth, capitalism will have eliminated absolute poverty by 2100.



The greatest danger of capitalism is that it enables human choice. The danger lies in the fact that unlike any other form of social organization, capitalism allows people to choose to abandon capitalism. Social institutions are nothing more than the formal and informal rules of the game that a society has adopted to regulate and direct the choices its citizens make.

Consider for example a recent vote that was almost taken by the Aliso Viejo, CA, City Council to ban Styrofoam cups the city. The proposed law was placed on the agenda by a paralegal working for the city that had stumbled across a prank website documenting the dangerous and deadly effects of Di-hydrogen Monoxide, a chemical used in manufacturing Styrofoam cups. The website noted that it was used extensively in the chemical, nuclear, and explosives industries, that inhalation could result in death, that in its liquid form it could cause diarrhea, vomiting, excess urination and electrolytic imbalances, and that in its gaseous and solid forms it could cause severe burns or death after prolonged exposure.

Had the council voted, they would have voted to ban products made with water (Di-Hydrogen Monoxide, H<sub>2</sub>O) from the city. A simple lack of information and a desire to appear to be on the right side of an uninformed and agenda driven debate almost resulted in a law being passed that was nothing short of ridiculous. Much like turning children into prostitutes so we can feel good about buying soccer balls made by machines.

Today, we face the same challenge with capitalism. Social institutions are dynamic and changing. They change in response to the perceived needs of the people they serve and the public servants that have stewardship over them. Without carefully teaching what capitalism is, what it is not, and what it has provided to us, we face the possibility that at some point people will choose another form of social organization and wind up banning water from the community.

There is already ample precedent. As discussed, as little as twenty years ago Zimbabwe was the bread-basket of Africa with a growing middle class, a positive current account and rising standards of living. A simple change in the people's perception of their social institutions led to simple changes in those institutions. Private property was eliminated, the rule of law was abandoned, markets were nationalized and entrepreneurs were punished. In a few short years Zimbabwe has gone from an African success to historical failure. People are starving, violence is rampant and human rights are non-existent.

We face similar challenges in our own country. Far too many people interpret capitalism in a Di-Hydrogen framework and in an effort to appear to be on the right side of an argument make statements and support policies that cannot themselves support inspection. In the name of the poor we eliminate mechanisms that have redefined poverty in the last hundred years. In an effort to assure equity we find ourselves ensuring that entire groups of our society remain equally poor.

Teaching the benefits of capitalism is important not only so that our students can be informed and appreciate the long process that created the wealth we enjoy, but enable them to cogently defend the institutions that will continue to create wealth for future generations.