Excerpt from *Common Sense Economics: What Everyone Should Know about Wealth and Prosperity*

Free trade: A nation progresses by selling goods and services that it can produce at a relatively low cost, and buying those that would be costly to produce domestically.

As is the case with domestic trade, international trade makes it possible for trading partners to produce and consume more goods and services than would be possible otherwise. The people of each nation benefit when they can acquire a product or resource through trade at a lower cost than they can produce it domestically. Resource endowments differ substantially across countries. Goods that are costly to produce in one country may be economical to produce in another. This generates the opportunity for gains from trade.

International trade also allows domestic producers and consumers to benefit from the economies of scale. When a trading arena expands, economies of scale are often a result of lower production costs when entrepreneurs can produce goods and services in large volume. Further, international trade promotes competition in domestic markets and allows consumers to purchase a wider variety of goods at lower prices.

If we are going to achieve higher living standards, we must expand the availability of the things people value. Trade helps us do so. When residents are permitted to trade with whomever they want, domestic consumers can find the lowest prices and the most value from their expenditures. Similarly, domestic producers can sell their goods and services wherever they can command the highest prices. As a result, consumers get more for their money, and we are able to produce a larger output from the available resources. It is this expansion in production and consumption that underlies higher income levels and living standards.

Why do so many countries adopt trade restrictions? Economic illiteracy on the part of both voters and policy makers plays a role. But, there is another crucially important factor here: the political power of organized special interests. Trade restrictions benefit particular producers and their resource suppliers, including some workers, at the expense of consumers and suppliers to other industries. Usually a specific industry that wants the government to provide them with protection from foreign rivals will be well organized and highly visible, while consumers, other workers, and other resource suppliers are generally poorly organized and their gains from international trade more widely dispersed. Predictably, the organized interest group will deliver more political clout, more votes, and more campaign funds. As a result, many politicians will cater to their views.

Conclusion: Expansion of world trade has made more and more goods and services available at economical prices. The poor, in particular, have benefited from the freer trade; worldwide, several hundred million poor people have moved out of poverty during the past quarter of a century. Residents of the United States have also benefited. International trade is a good example of how we improve our own well-being by helping others improve theirs.

Trade, institutions, and economic systems

Economic analysis indicates that the institutional environment will affect the performance of economies. Stable and predictable government policies, rule of law, and economic freedom establish the foundation for gains from trade, private investment, and innovation, which are the key sources of the growth process.

How much do institutions and policies matter? The satellite image of the Korean peninsula at night provides insight on this question. South Korea is lit like a Christmas tree while North Korea is dark as a dungeon. What accounts for the difference? The Korean people share much of the same historical heritage, similar backgrounds and identical cultures. But the institutional structure of the two countries is dramatically different. South Korea relies primarily on markets while North Korea is a socialist centrally planned economy.

How much do institutions and policies matter? In order to answer this question, we need a way of comparing the institutions and policies of different countries. In the mid-1990s, the Fraser Institute of Vancouver, British

Columbia, began work on a special project designed to develop a cross--country measure of economic freedom. Several leading scholars, including Nobel Laureates Milton Friedman, Gary Becker, and Douglass North, participated in the endeavor, as well as James Gwartney, Robert Lawson and Joshua Hall. This project culminated with the development of the *Economic Freedom of the World* (EFW) index at: http://www.freetheworld.com/ (Links to an external site.). Now published by a worldwide network of 75 institutes, this index measures the extent to which a country's institutions and policies are consistent with economic freedom; that is, with personal choice, private ownership, voluntary exchange, and competitive markets. The index incorporates 42 separate components and provides ratings for approximately 150 countries.

In many ways the EFW index reflects the elements of economic progress outlined above. To achieve a high EFW rating, a country must provide secure protection of privately owned property, evenhanded enforcement of contracts, and a stable monetary environment. It also must keep taxes low, refrain from creating barriers to both domestic and international trade, and rely more fully on markets (rather than government expenditures and regulations) to allocate goods and resources. Hong Kong, Singapore, Switzerland, New Zealand, Canada, Australia, and the United States head the list of the most persistently free economies during the past two decades. At the other end of the spectrum, Guinea-Bissau, the Democratic Republic of the Congo, Algeria, Venezuela, and Zimbabwe are among the least free economies.

If institutional and policy factors really do affect economic performance, countries with persistently high EFW ratings should do much better than those with lower ratings. Indeed, this has been the case. Detailed studies indicate that countries with more economic freedom have higher investment rates, higher income levels per person, and more rapid economic growth than economies that are less free. Moreover, the difference is striking. For example, in 2010 the income per person level in the freest quartile of countries was about seven times the figure for the least free quartile. Institutions and policies matter, and they matter in a big way.

Gwartney, James, Richard Stroup, Dwight Lee, Tawni Ferrarini and Joseph Calhoun. 2016. *Common Sense Economics*: *What Everyone Should Know about Wealth and Prosperity.* New York, NY: St. Martin's Press.