

**TEACHER'S GUIDE**

# **The Price System**

**5 MINUTE: ECONOMICS**



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Video Page



# *5 Minute Economics: The Price System*

## **Introduction**

This video is presented in two segments. For each segment, this Teacher's Guide provides:

- Sample worksheets for easy photocopying
- Class discussion questions
- Post-video quiz
- Extra credit ideas and post viewing activities

A suggested lesson plan progression...

- Distribute "Worksheet: Segment 1" and view Segment 1. Discuss students' responses. Assign as homework or class project a "Post Viewing Activity."
- Repeat for Segment 2 and cover discussion questions.
- Administer post-video quiz.

## *5 Minute Economics: The Price System*

This video borrows heavily from Leonard Read's classic essay, "I, Pencil: My Family Story as told to Leonard E. Read" (1958). The essay is available at [www.econlib.org/library/Essays/rdPncl1.html](http://www.econlib.org/library/Essays/rdPncl1.html). Mr. Read was the founder and first president of the Foundation for Economic Education ([www.fee.org](http://www.fee.org)), which publishes a monthly journal called *The Freeman*.

The speaker in the video, Milton Friedman, is a Nobel Prize-winning economist who begins his classic treatise, *Free to Choose*, with a summary of "I, Pencil" and an examination of the price system. (See Chapter One, "The Power of the Market.") This chapter, and indeed the entire book, is highly recommended for those wishing to pursue more information about the concepts outlined in the video.

### **Key Concepts**

This video makes use of or refers to the following key economic concepts:

**Adam Smith** is considered the founder of modern economics. As Friedman says in *Free to Choose*, Smith's "key insight" in his treatise *The Wealth of Nations* was that **voluntary exchange** meant that both parties could benefit. As individuals pursued their own gain, they contributed to society's gain (as if guided by an **invisible hand**). This was most true in an environment of personal and political freedom, where decisions were guided by the **price system**.

Prices work in THREE ways: to transmit information, to serve as incentives for production, and to determine the distribution of income. Some examples of how these work:

1. *Transmitting information*: If supply is disrupted, for example, producers may charge more. If prices rise, consumers may look for substitute products, restoring equilibrium between supply and demand.
2. *Incentives for production*: A product that is in short supply will see prices rise; this may allow for higher wages in that industry. Higher wages will attract more labor to meet the need.
3. *Distributing income*: Wages and salary (the 'price' of labor) and other income result from choices. Occupations in low supply, especially those that require high degrees of training and skill, attract workers by offering higher incomes. Occupations that are oversupplied or unnecessary see their relative value drop.

One of the keys to economic growth is **productivity**. Smith argued that the division of labor, or **specialization**, was key to increasing productivity. This video shows that no one knows how to make a pencil because no one has the capacity to know all there is to know to accomplish that goal. The price system allows people to specialize on a portion of the job, say the chemistry of making steel, which an individual can come to understand AND IMPROVE UPON, thus progress is made and complicated products are manufactured.

**Coercion** or other means of manipulating the system (governmental or otherwise) corrupt it. Because of human ingenuity, wealth is NOT a **zero-sum game**, where one party gains and one party loses in competition for a permanently defined piece of "economic pie." Instead, new wealth can be created; this occurs best when political, personal, and economic freedoms intersect. Of course, government is necessary, particularly when providing goods and services that individuals can't or won't pay for on their own (national security, for example). Such goods, paid for with taxes, are known as **public goods**.

Name: \_\_\_\_\_ Date: \_\_\_\_\_

## ***5 Minute Economics: The Price System*** **Worksheet 1**

### **Segment 1**

1. What is the name of the famous book written by Adam Smith?
2. What does Milton Friedman mean by saying there is nobody in the world who knows how to make a pencil?
3. The factors of production are land, labor, capital, and entrepreneurship. What factors of production go into the creation of a pencil?
4. How are people who are NOT involved in producing wood, graphite, brass and rubber still involved in the process of producing pencils?
5. How does profit operate as an incentive to businesses? If profit motivates business owners, what motivates consumers?

Dr. Friedman prefaced his remarks on the miracle of the price system by saying, "Provided they are voluntary transactions..." Why would this make a difference?

How much government intervention into the economy would Adam Smith advocate?

Name: \_\_\_\_\_ Date: \_\_\_\_\_

## ***5 Minute Economics: The Price System*** **Post Viewing Activities: Segment 1**

1. Using the CIA Factbook, provide a list of nations that follow a free market economy, a traditional economy, and a command economy. Include a map showing the location of each.
2. Make a list of every country mentioned in the production of a pencil. Using the map provided, label each country listed. What trade patterns do you see? Explain.

3. **Division of Labor Simulation:**

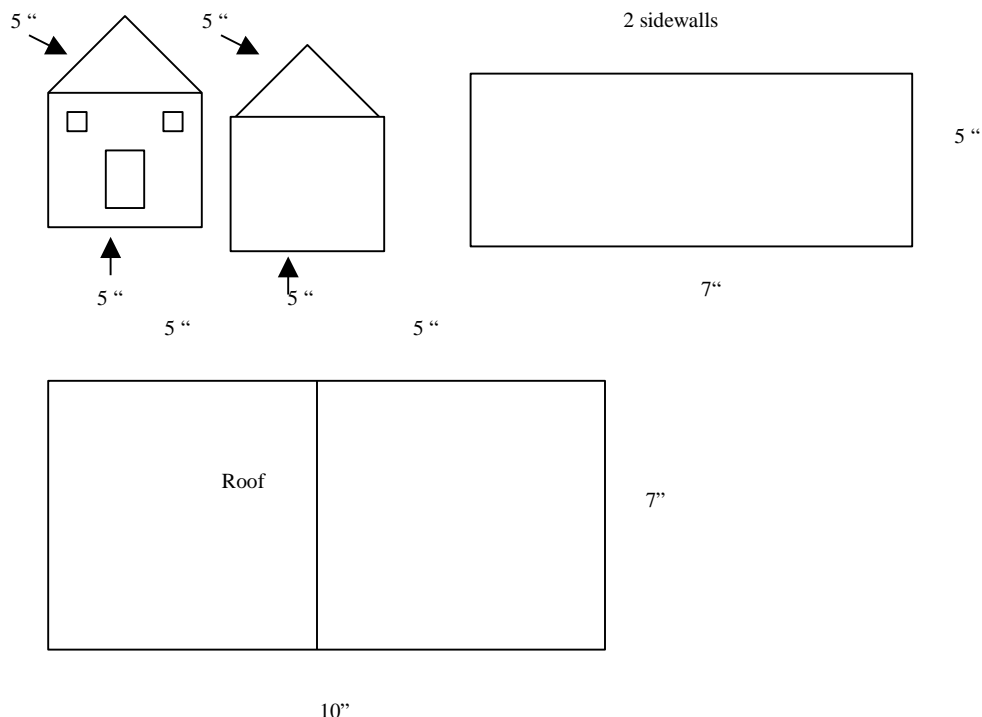
Stage 1: Provide students with the dimensions of a paper house (below), and ask them to gather the needed resources at the front of the room. Each student will work to produce the most houses in a given time (recommended time is 20 minutes).

Stage 2: Now divide the class into four groups, with each specializing in one part of the house: front/back walls, side walls, roofs and assembly. The same amount of time is given.

**Result:** Students will see that Stage 2 produced a larger quantity of houses in the same amount of time. This illustrates the efficiency of the division of labor.

**Materials needed:** Scissors, cellophane tape and construction paper.

**Suggested shape:**



Name: \_\_\_\_\_ Date: \_\_\_\_\_

## ***5 Minute Economics: The Price System*** **Worksheet 2**

### **Segment 2**

1. What is the price system?
2. Milton Friedman says the price system adds to world co-operation. Explain.
3. How does the price system facilitate supply and demand? What three key pieces of information does the price system provide?
4. How does the price system enhance creativity and progress?
5. What is the “zero sum game” philosophy? How is it different from the concept of the invisible hand?
6. Do you agree that wealth is a “fixed pie”? In other words, are you necessarily worse off if I make more money as your teacher? Why or why not?

What might happen if the government creates artificial requirements governing all purchasing transactions? What might happen if these governmental restraints were removed? Would these goods and services disappear from the market? Explain.

How are the concepts of a free market, personal, economic and political freedom interrelated?

Name: \_\_\_\_\_ Date: \_\_\_\_\_

## ***5 Minute Economics: The Price System*** **Post Viewing Activities: Segment 2**

1. Interview 50 people to determine the minimum and maximum prices they would pay for a typical pencil. From your interviews, compile a demand schedule and create a demand curve for pencils.
2. Watch the film Wall Street. Write an essay describing how the concepts presented by the character Gordon Gekko are different from those presented by Milton Friedman.
3. Opportunity cost is defined as the next best alternative forgone when making a decision. Create a list of at least 15 other items that could be produced given the same resources necessary for producing one pencil.

## *5 Minute Economics: The Price System*

### **Additional Discussion Questions: Segments 1-2**

1. Human capital is defined as investment in education and skills. How could human capital be improved to enhance the production of pencils?
2. Using information from the video, explain how scarce resources are most efficiently allocated.
3. For the pencil to make it to Staples, what has to happen? How many other kinds of industries are involved?
4. Consider for a moment the concepts of a free market economy, personal, political and economic freedom. Which one is most important to you? Which one is the least important? Can you foresee one existing without the other? Explain.
5. Are there areas in which the government **MUST** be involved? In your opinion, when should a government spend tax dollars to provide goods and/or services for its citizens?



Name: \_\_\_\_\_ Date: \_\_\_\_\_

## ***5 Minute Economics: The Price System***

### **Quiz**

***Part I. Fill in the blanks with the appropriate terms:***

1. In a free market, people trade for goods and services through a system known as \_\_\_\_\_ exchange. Because of this, both sides feel better off as a result of the trade.
2. Dr. Friedman argues that free markets and political and personal \_\_\_\_\_ are linked, and that the best possible system embraces all three.
3. Adam Smith described an \_\_\_\_\_ which “governed” the market without a central “mastermind.”
4. Without central or government planning, the machinery that enables peaceful cooperation and economic growth is the \_\_\_\_\_.
5. Dr. Friedman argues that one major fallacy in economic thinking is the belief that wealth is a \_\_\_\_\_.

***Part II: Answer in a few sentences.***

1. How did the behavior of Emily and Emerson demonstrate the economic concepts in the video?
2. We can all name the ‘parts’ of a pencil—wood, graphite, brass, rubber. How are people who do NOT produce those goods still involved in the process of producing pencils?
3. Under what conditions should the government be involved in providing goods and services?
4. How does the price system facilitate progress?

***Part III: Select TWO of the following to answer in paragraph form.***

1. Think of a situation in which you or your family were compelled to pay more for something than you thought was fair OR to sell something for less than you thought it was worth. What was your reaction? With that in mind, how is the system disrupted if government decree (or **fiat**) replaces the price system as the incentive for production?
2. Describe a situation where new ideas or technology created new wealth.
3. Friedman argues that economic cooperation can exist between groups who dislike each other because of self-interest. Defend or refute this idea.

# *5 Minute Economics: The Price System*

## **Answer Key**

### **Part I:**

1. Voluntary
2. Freedom
3. Invisible hand
4. Price system
5. Zero-sum game

### **Part II:**

1. Emily and Emerson negotiated a trade – notes for water – in which each student felt better off (a fair trade). Students might also notice that Emily was preparing a report, and that her *incentive* to do well led her to take notes and clarify information.
2. Friedman pointed out that someone had to make the wood-cutting saws, others had to transport the goods from one place to another, etc. Students could also note the use of computers or other technology.
3. Government should be involved when individuals are incapable of obtaining the necessary good on their own. (What is *necessary*, of course, is open to debate.)
4. The price system allows people to specialize on a portion of the job, which an individual can come to understand and improve upon, thus progress is made and complicated products are manufactured.

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