ECONOMISTS AND ECONOMIC POLICY

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The founder of our discipline as we view it today was Adam Smith. His book *The Wealth of Nations*, published in 1776, is both the first scientific treatise in economics and one of the most effective tracts intended to influence public policy that has ever been published. Nonetheless, it took seventy years before the doctrines of *The Wealth of Nations* were adopted in Great Britain, before his arguments for free trade and against mercantilist policies were put into practice.

From that time to this, economists have followed the same dual goal: to improve our understanding of how the economy works and to influence public policy. In trying to influence policy, economists have typically adopted a public interest view of government. They have written as if governmental officials, whether elected or appointed, were selflessly dedicated to achieving the public's welfare and as if the role of economists were simply to figure out how to do so—to decide what is the right thing to do and to persuade people dedicated to the public interest that it is the right thing to do.

The most distinguished representative of that point of view is doubtless John Maynard Keynes. He made his attitude crystal clear in a letter to Friedrich Hayek commenting on the *Road to Serfdom*. The excerpt from his letter that is most often quoted is: "[I]t is a grand book. . . . [M]orally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in a deeply moved agreement." It comes as a surprise to most people that Keynes gave such an unqualified endorsement to the *Road to Serfdom*. However, when you read the rest of the letter you come to the inevitable "but." (Incidentally, "but" is the most important single word in most letters, like the one I got the other day from a gentleman who said he was 98 percent in agreement with my views in favor of free markets, *but* we must continue to protect honey from foreign competition in order to have bees around to pollinate the crops.) And so Keynes came to his "but": "What we need . . . is not a change in our economic programmes . . . but perhaps even . . . an enlargement of them. . . . [W]hat we need is a restoration of right moral thinking—a return to proper moral values in our social philosophy. . . . Dangerous acts can be done safely in a community which thinks and feels rightly, which would be the way to hell if they were executed by those who think and feel wrongly."[1]

That approach to public policy was Keynes's political legacy to economists. I believe that it may well be both a more important and a more dangerous legacy than his economic legacy.

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1. John Maynard Keynes [1980, 385, 387, 388].

Economic Inquiry
Vol. XXIV, January 1986

I'm no exception to my generalization about the typical approach of the economist in dealing with public policy. Most of my own work dealing with public policy has had the same character of proceeding as if I were addressing governmental officials selflessly dedicated to the public interest. As you know, for many years I have studied and analyzed monetary policy. On the basis of that work, I have attempted to persuade the Federal Reserve System that it was doing the wrong thing and that it ought to adopt a different policy. That was time ill-spent. It has had no appreciable results on the behavior of the Federal Reserve System and there is a good reason why it did not: because the public-interest characterization of government is basically flawed. That way of viewing government is very different from the way we view business. We do not regard a businessman as selflessly devoted to the public interest. We think of a businessman as in business to improve his own welfare, to serve his own interest. Adam Smith taught us that "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages."[2] In his famous phrase, though "every individual intends only his own gain, he is . . . led by an invisible hand to promote an end which was no part of his intention."[3]

Why should we regard government officials differently? They too aim to serve their own interest, and in government as in business we must try to set up institutions under which individuals who intend only their own gain are led by an invisible hand to serve the public interest, instead of, as so often happens, by an "invisible foot" to serve private interests that it was no part of their intention to serve. The inconsistency between our treatment of government and our treatment of business has long been recognized, but generally only in asides.[4] The great contribution of what has become known as the theory of public choice, developed by such writers as Anthony Downs in *The Economic Theory of Democracy*, and James Buchanan and Gordon Tullock in *The Calculus of Consent*, has been to make this inconsistency explicit, and to force all of us to recognize that we should analyze governmental officials in the same way that we analyze businessmen, as promoting their own self-interest.

I can illustrate the importance of this change of viewpoint by using it to show why it was a waste of my time to try to convert the Fed to my point of view. Suppose that ten or twenty years ago the Federal Reserve had adopted the policies that I and other monetarists were proposing. Suppose that it had then embarked on a policy of increasing the quantity of money at about 3 percent a year, year after year, and doing nothing else—at least in respect of aggregate monetary policy. I believe that there would be wide agreement among economists in general and monetary economists in particular that

2. Smith [1930, 16].
3. Smith [1930, 421].
4. An exceptionally explicit statement is made by Joseph Schumpeter [1949, 208-209].

such a policy would have avoided the major inflation of the 1970s and the resulting turmoil in the financial structure. It would also have avoided the ups and downs in interest rates and the economy of the early 1980s. Today, the economic situation of the U.S. and of the world would be very different and, I believe, far preferable.

Indeed, even an institution that I disapprove of very much, the International Monetary Fund, might still be serving its original purpose. Its purpose disappeared in 1971 when the Bretton Woods agreement was ended and floating exchange rates were introduced, but it's not only old soldiers who don't die. From 1971 on, the IMF was an institution in search of a purpose instead of a purpose in search of an institution.

But now look at another set of consequences of the hypothetical adoption by the Fed of a policy of steady monetary growth at 3 percent a year. Is there any possibility whatsoever that polls of public opinion would, on that hypothesis, now be recording that the second most important person in the U.S. is the Chairman of the Federal Reserve? If the Federal Reserve had followed that policy, the readers of this talk, let alone members of the public at large, would not even know the names of the members of the Federal Reserve Board any more than they know the names of the officials who run the Bureau of Engraving and Printing. The Federal Reserve would have become a bureaucratic agency carrying on a simple mechanical task. It would be performing a useful function, as the Bureau of Engraving and Printing does. Clearly, it was not in the self-interest of the Federal Reserve hierarchy to follow the hypothetical policy. It was therefore a waste of time to try to persuade them to do so.

To avoid misunderstanding, let me stress that I'm not criticizing the people in the Federal Reserve System just as I'm not criticizing businessmen when I say that they pursue their self-interest. On the contrary, as already emphasized, I and most of us as economists have learned from Adam Smith that the world will run best if there is a fundamental framework under which people who pursue their self-interest are led by an invisible hand also to serve the public interest. I'm not criticizing anybody except those who were responsible for setting up institutions that are not consistent with such a framework. The Federal Reserve System puts a great deal of power in the hands of a few people and it is so constructed that it has been in their self-interest to pursue a policy which, I believe, has been very harmful for the public rather than helpful. Let me make explicit also that I am not accusing the persons in control of monetary policy of *knowingly* doing harm. On the contrary. I have no doubt that they are sincerely persuaded that they acted in the public interest and that economic conditions would have developed in an even more undesirable way if they had acted differently. Everyone of us knows that what is in his interest is in the public interest—and as Charles Wilson said about General Motors, "and conversely."

From the public choice perspective, the interesting question is, how can economists influence public policy as well as simply describe it? Simply describing it is not an unimportant task. Indeed, the major task of scholars is to understand the way the world works rather than to influence it. However, insofar as we want not only to understand the way the world works, but also would like to influence it, how can economists exercise influence while at the same time recognizing that they are dealing with human beings who pursue their own interest whether they be politicians whose self-interest is to get re-elected, or members of bureaucracies whose self-interest is to have that bureaucracy bigger and more powerful, or idealists whose self-interest is to promote a special version of the public interest? After all, the notion of self-interest is not restricted, as we economists long ago learned, to narrow pecuniary self-interest. It includes many nonpecuniary motives. The saints of this world are pursuing their self-interest no less than the devils.

In my opinion, economists can nonetheless have an influence on public policy in three ways. The oldest, the way that we have practiced the most, is simply to try to inform the public, to give the public a better idea of what is in the public's own interest. The most obvious example is the near-unanimity among economists on the advantages of free trade. We do not have tariffs because they are in the self-interest of the public at large. We have tariffs because most members of the public are uninformed about the effect of tariffs on them. A particular tariff tends to be promoted by a small concentrated group—producers of a product, including both employers and employees. It pays them to devote a lot of effort and to spend a lot of money to get a tariff or other barrier to foreign competition adopted. Consider the case I mentioned earlier—honey. Few if any of us know the names of the producers of honey, but they do and they are in touch with one another. It is worth their while to lobby for restraint on the importation of honey. The costs of the restraint are spread thinly among the rest of us. It costs each of us a few cents or a few dollars a year. It is not rational for us even to spend the effort required to learn how much harm the honey tariff does to us. As a result, legislators, considering each item separately, can identify the support at the polls that they would gain by favoring the restraint; they cannot identify any support that they would lose; hence they tend to vote for it.

To take into account the insights of the public choice school, it's hopeless for economists to try to persuade the public that its interests are harmed by a particular tariff. We can't possibly hope to educate the public at large sufficiently about honey to make it politically profitable for politicians to vote against restraining imports of honey—let alone, to make it personally profitable for economists to make the attempt. We weren't even able— or sufficiently motivated—to do that about import quotas on automobiles from Japan, even though that restraint on foreign trade probably cost the public more than any other single interference with foreign trade. Quotas on the import of sugar are another striking example. Because of them, we all pay five times the world price for every pound of sugar we use.

In order to be successful in promoting free trade, we must educate the public about tariffs in general, about the virtues of free trade as a general policy, and not dissipate our energies by attacking each tariff separately.

They can provide illustrations, and nothing more. Clearly, that is not an easy task. We have been trying it for two centuries without notable success, so obviously we have not been tackling it the right way.

That leads me to the second way in which economists can hope to influence public policy. That way is by analyzing the changes in institutional arrangements that would bring about the desired results and trying to persuade the public to introduce those institutional changes rather than trying to influence policy makers directly. For example, in the case of the tariff, I believe that rather than attacking each individual restraint as it is proposed in Congress, we might have a greater chance of success if we promoted a constitutional amendment saying "Congress shall make no laws imposing tariffs or trade restrictions," or an even broader constitutional amendment saying "Congress shall make no laws prohibiting voluntary contracts between consenting adults." Such an amendment would eliminate tariffs, as well as many restrictions on internal trade, because a seller in a foreign country and a buyer here constitute two consenting adults. I don't mean here to give the precise wording of an amendment; my point is simply to set forth the principle that what we need to do to be effective in promoting free trade is to direct our efforts at changing institutional arrangements through a constitutional provision or in some other way. Such a procedure has two advantages. First, the cost of foreign restraints as a whole on an individual consumer is substantial, sufficiently large to make it worth his while to be informed about them—provided, there is a chance of putting that information to effective use. Second, it takes only one sustained "crusade" to enact a constitutional amendment, and once enacted it has a continuing effect, whereas it takes a continuous campaign to defeat individual tariff proposals.

A public-choice perspective will sometimes suggest proceeding in ways that seem wrong economically. Let me illustrate with the current Congressional action on the budget. There is wide agreement that the Federal government budget should be cut. How should the budget be cut? Straightforward economic reasoning recommends operating on the margin, namely, cutting a little bit here, a little bit there, and a little bit somewhere else. Economists are well acquainted with that implication of equating marginal costs and returns. We all are amused when consumer researchers ask people what they would do if they had, say, $200 extra to spend, and report that people answer that they would spend it on a single large item—a refrigerator or a calculator or the like. We all know what consumers would actually do. They would spend 5 cents extra on toothpaste, 3 cents extra on something else, and so on.

The marginal principle similarly implies that the optimal way to cut the government budget is to cut it evenly all down the line. However, in terms of political effects, that is precisely the wrong way to do it. The right way to do it is to eliminate agencies, to eliminate functions. Why? If Amtrak's budget is cut by 15 percent, next year the Amtrak bureaucracy will still be there pleading for a higher budget. If you eliminate Amtrak, there will be no bureaucracy in existence to lobby for Amtrak. Eliminate agencies, and the gain will be permanent; make marginal cuts, and the gain will almost invariably be temporary. Both the President, who wants to cut spending, and his Congressional opponents, who clearly do not, have recognized this principle. The President, in the budget he submitted to Congress, proposed to terminate more than a dozen programs, including Revenue Sharing, Job Corps, Amtrak, the Small Business Administration, etc. The Senate cut that down to about five or six, the House has now reduced it to two and proposed instead to make little cuts all over. The final resolution passed by both Houses terminates no major programs and gets its advertised budget cuts by a combination of small cuts and mirrors. The result: the bureaucracy lobbying for larger appropriations will remain intact. That, I believe, is a nice illustration of how the economic analysis of politics makes it necessary to modify correct economic principles when they are applied to political issues.

The campaign underway to enact a constitutional amendment to require a balanced budget and limit spending is another example of attempting to influence policy by changing institutional arrangements so as to make it in the self-interest of legislators to behave in a way that is in the public interest. Currently, if a lobbyist asks a legislator to vote for a program to do something—it's always to do something good, of course—and the legislator says to him: "I can't do that because that would mean higher taxes," the lobbyist says, "What are you talking about? You are a mean nasty fellow. You want to grind those poor people [or whatever group would benefit from the legislation] under your heels." The legislator has no effective answer. He knows as well as the lobbyist that any increase in taxes to finance the specific program would be small and widespread, and so invisible, while the specific spending action would be concentrated and highly visible. That is why the process of considering each spending action separately produces a total budget that is larger than the public desires. That defect in our institutional structure explains the paradox that every public opinion poll shows a majority of the public in favor of a smaller budget and opposed to higher taxes, yet at the same time, Congress consistently votes for more spending and prefers higher taxes to spending restraint.

If a constitutional amendment required total spending to be limited, the legislator's self-interest would change. He could now tell the lobbyist, "You're right. Your project is excellent. However, the Constitution limits the total amount we can spend. I can only vote for your project if I vote less for something else. What else shall I vote less for?" That would pit one special interest against another and change the rules of the game in such a way that the legislator would now find it in his self-interest to operate in the public interest. Similar considerations underlie the attempt by some of us to promote a constitutional amendment enacting a monetary rule.

A third, and perhaps the most effective, way that economists can and do influence public policy is by keeping options open for times of crisis. Major changes in institutional arrangements seldom if ever occur except at a time of crisis. The only reason we have a ghost of a show now of enacting a constitutional amendment to require a balanced budget and to limit spending is because there exists a budgetary crisis. Most commentators bemoan the large budget deficit. I welcome it. The deficit is the only thing that is forcing us to think seriously about how to control Federal spending. The economic effect of the deficit is unquestionably bad; but the political effect of the deficit is good.

The best recent example of this third kind of influence is the introduction of floating exchange rates. From the end of World War II to 1971, the Bretton Woods fixed exchange rate system was in effect. Some economists like myself, Gottfried Haberler, and others had for decades been writing and talking about the advantages of floating exchange rates compared with the existing system of administratively pegged exchange rates. The reaction of policy makers was always that we were unrealistic theorists who simply didn't understand how the "real" world worked. I remember participating in a prestigious gathering of international bankers in Copenhagen at which I shared a platform with the then Managing Director of the IMF. He dismissed out-of-hand my support for floating exchange rates, calling it utterly unworkable and unrealistic. Fixed exchange rates, he proclaimed, was the only feasible system. Two years later, after Bretton Woods had been abandoned, the same group met in Montreal. I again shared a platform with the Managing Director of the IMF—a new one—but this time his line was, "Of course, floating exchange rates are the only feasible possibility in today's world."

As this example demonstrates, floating exchange rates were not adopted because we persuaded anybody that floating exchange rates were the right policy. Floating exchange rates were adopted because a crisis emerged—the drain of gold from the United States—that required drastic action. That option was open because economists had been writing and talking about floating exchange rates. If that option hadn't been open, if it hadn't been a well thought through scheme with respectable academic backing—indeed backed by most economists specializing in money and international trade—something would still have had to be done. However, it would almost certainly have been something other than floating exchange rates.

I want to talk about another example because I do not quite know how to fit it into my tripartite classification of ways economists can influence policy. In his talk at the 1985 annual meeting of the WEA, Walter Oi referred to the influence of economists in abolishing the draft and establishing a volunteer army. He is right, and yet his example doesn't easily fit into my tripartite schema. In December 1966, a large-scale conference on the draft was convened at the University of Chicago under the leadership of Sol Tax. It was unusual because the conferees included not only academics from many fields but also political activists and politicians: economists like Walter Oi and myself, anthropologists like Margaret Mead, politicians like Senator Ted

Kennedy, and so on. It was unusual in a more important way: it was one of the few conferences that I've ever attended in which opinions were changed. A vote taken at the outset of the conference recorded about two-thirds of the participants in favor of a draft, only about one-third in favor of a volunteer army. A similar vote taken at the end of the conference recorded the reverse: about two-thirds in favor of a volunteer army and only about one-third in favor of a draft.

In my opinion, the one episode in that four-day conference that did more than anything else to change opinions was a talk that Walter Oi gave on the economics of the draft. It was an extraordinarily effective performance. Walter is always a very good speaker, but on this particular occasion he was particularly effective, if I may be pardoned for referring to his virtual blindness, because it meant that he was obviously not speaking from personal interest. There he was, with a seeing-eye dog, in front of a large audience talking in his calm, unemotional, highly rational way about the inequity of the draft, about how it was a highly selective and discriminatory implicit tax on the people who were drafted. He presented the case effectively, but I have no doubt that the emotional aura he unwittingly created had much to do with changing the minds of many participants.

Subsequently, when President Nixon appointed a President's Commission on an All Volunteer Armed Force—partly, I may say, under the influence of another economist, Martin Anderson—it consisted of twelve people of whom at the outset six were in favor of a volunteer army and six in favor of the draft. Three of the six in favor of a volunteer army were economists (Alan Greenspan, W. Allen Wallis, and myself), and there were no other economists on the commission. We ended up with a unanimous report in favor of a volunteer army. I must admit that this is one case in which I believe economists did influence public policy through their arguments, and not in the ways I have been talking about, so I don't quite know where to fit it into my pattern.

This leaves me, and this is my closing comment, with a paradox about economists. We too are pursuing our own interests. We cannot in good conscience interpret ourselves as behaving differently from those we analyze. We cannot treat ourselves as an exception. The question then arises: Is it in our self-interest to promote public policy in the ways I have described? That is by no means clear. After all, the New Deal was the greatest employment program for economists that ever existed. I can speak with feeling about it; that's where I got my first job. Most of the readers of this talk are too young to remember how important the New Deal was in opening jobs up for economists. More generally, government is a major source of employment for economists, both directly and through the effect of government intervention on private enterprises. One of the oldest government interventions, antitrust, for example, creates a large and highly remunerative demand for economists as expert witnesses on both sides of many antitrust cases. Similarly, other government interventions create jobs for us in private enterprises to figure out the effects of the interventions and to provide arguments for changes favorable to particular enterprises. They also create jobs for us in government to analyze the effects of the interventions and provide arguments for their retention or modification. I've often wondered whether I was being cynical in interpreting along these lines the tendency for economists to favor free markets in general but, at the same time, to be extremely ingenious in figuring out exceptions that could be justified by externalities, imperfect markets, distributive effects, and so on.

To give another example, one reason for the prompt acceptance by the profession at large of John Maynard Keynes's *General Theory* was because it opened up such wonderful opportunities for employment and influence by economists. After all, if an economy could be controlled by altering taxes and spending, who was going to do the altering of the taxes and spending? Who was going to be occupying those positions of power? I believe that one reason our monetarist rule has had such unenthusiastic acceptance in many quarters is because it would sharply reduce the number of jobs available for economists. So I don't believe we're any exception.

Let me repeat what I said earlier about the businessmen and the government officials. I'm not saying that economists, any more than the rest of the population, deliberately and explicitly put their self-interest above the public interest. I referred earlier to the famous statement during World War II by "Engine" Charlie Wilson, then head of General Motors, that "What's good for General Motors is good for the country, and conversely." Similarly, everyone of us knows that what's good for us is good for the country, and conversely. Every member of the Federal Reserve Board knows that he's an important person and is in an important position. It would be psychologically impossible for him to believe that his actions are harmful. Similarly, the economists who find external effects in every corner of the economy are in the same position. So I'm not saying that anybody explicitly uses his position to do harm; I'm saying something very different. I'm saying that as analysts we should recognize that all of us, ourselves included, are human beings who know our own self-interest better than we know anything else and who will pursue our self-interest. As Armen Alchian once said, "One thing you can depend on absolutely everybody to do is to put his interest above yours." Again, let me emphasize that self-interest is not restricted to narrow material interest. It includes the desire to serve the public interest, to help other people.

To conclude, how economists have in the past and can in the future influence public policy is an important topic for scientific research. The public choice school has made an important contribution to that topic, but so have the rest of the economics profession—monetary and price theorists, and applied economists alike. Despite my reservations and qualifications, my own self-interest leads me to believe that on the whole economists have exercised a good influence. Maybe tariffs are 10 percent lower than they otherwise would be because of our long-term advocacy of free trade; if so, that 10 percent would pay the salaries of the members of the economics profession many times over.

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