Capitalism and Freedom

Milton Friedman

with the assistance of Rose D. Friedman

With a new Preface by the Author

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TO

JANET and DAVID

AND THEIR CONTEMPORARIES

WHO MUST CARRY THE TORCH OF LIBERTY

ON ITS NEXT LAP

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Preface, 1982

The lectures that my wife helped shape into this book were delivered a

quarter of a century ago. It is hard even for persons who were then active, let

alone for the more than half of the current population who were then less than

ten years old or had not yet been born, to reconstruct the intellectual climate of

the time. Those of us who were deeply concerned about the danger to freedom

and prosperity from the growth of government, from the triumph of welfare-

state and Keynesian ideas, were a small beleaguered minority regarded as

eccentrics by the great majority of our fellow intellectuals.

Even seven years later, when this book was first published, its views were

so far out of the mainstream that it was not reviewed by any major national

publication not by the New York Times or the Herald Tribune (then still being

published in New York) or the Chicago Tribune, or by Time or Newsweek or even

the Saturday Review though it was reviewed by the London Economist and by

the major professional journals. And this for a book directed at the general

public, written by a professor at a major U.S. university, and destined to sell

more than 400, 000 copies in the next eighteen years. It is inconceivable that

such a publication by an economist of comparable professional standing but

favorable to the welfare state or socialism or communism would have received a

similar silent treatment.

How much the intellectual climate has changed in the past quarter-

century is attested to by the very different reception that greeted my wife's and

my book Free to Choose, a direct lineal descendant of Capitalism and Freedom

presenting the same basic philosophy and published in 1980. That book was

reviewed by every major publication, frequently in a featured, lengthy review. It

was not only partly reprinted in Book Digest, but also featured on the cover. Free

to Choose sold some 400,000 hardcover copies in the U.S. in its first year, has

been translated into twelve foreign languages, and was issued in early 1981 as a

mass-market paperback.

The difference in reception of the two books cannot, we believe, be

explained by a difference in quality. Indeed, the earlier book is the more

philosophical and abstract, and hence more fundamental. Free to Choose, as we

said in its Preface, has "more nuts and bolts, less theoretical framework." It

complements, rather than replaces, Capitalism and Freedom. On a superficial

level, the difference in reception can be attributed to the power of television.

Free to Choose was based on and designed to accompany our PBS series of the

same name, and there can be little doubt that the success of the TV series gave

prominence to the book.

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That explanation is superficial because the existence and success of the

TV program itself is testimony to the change in the intellectual climate. We were

never approached in the 1960s to do a TV series like Free to Choose. There

would have been few if any sponsors for such a program. If, by any chance,

such a program had been produced, there would have been no significant

audience receptive to its views. No, the different reception of the later book and

the success of the TV series are common consequences of the change in the

climate of opinion. The ideas in our two books are still far from being in the

intellectual mainstream, but they are now, at least, respectable in the intellectual

community and very likely almost conventional among the broader public.

The change in the climate of opinion was not produced by this book or the

many others, such as Hayek's Road to Serfdom and Constitution of Liberty, in

the same philosophical tradition. For evidence of that, it is enough to point to the

call for contributions to the symposium Capitalism, Socialism and Democracy

issued by the editors of Commentary in 1978, which went in part: "The idea that

there may be an inescapable connection between capitalism and democracy has

recently begun to seem plausible to a number of intellectuals who once would

have regarded such a view not only as wrong but even as politically dangerous."

My contribution consisted of an extensive quotation from Capitalism and

Freedom, a briefer one from Adam Smith, and a closing invitation: "Welcome

aboard. nl Even in 1978, of the 25 contributors to the symposium other than

myself, only 9 expressed views that could be classified as sympathetic to the

central message of Capitalism and freedom.

The change in the climate of opinion was produced by experience, not by

theory or philosophy. Russia and China, once the great hopes of the intellectual

classes, had clearly gone sour. Great Britain, whose Fabian socialism exercised a

dominant influence on American intellectuals, was in deep trouble. Closer to

home, the intellectuals, always devotees of big government and by wide

majorities supporters of the national Democratic party, had been disillusioned by

the Vietnam War, particularly the role played by Presidents Kennedy and

Johnson. Many of the great reform programs such guidons of the past as

welfare, public housing, support of trade unions, integration of schools, federal

aid to education, affirmative action were turning to ashes. As with the rest of the

population, their pocketbooks were being hit with inflation and high taxes. These

phenomena, not the persuasiveness of the ideas expressed in books dealing with

principles, explain the transition from the overwhelming defeat of Barry

Goldwater in 1964 to the overwhelming victory of Ronald Reagan in 1980two

men with essentially the same program and the same message.

What then is the role of books such as this? Twofold, in my opinion. First,

to provide subject matter for bull sessions. As we wrote in the Preface to Free to

Choose: "The only person who can truly persuade you is yourself. You must turn

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the issues over in your mind at leisure, consider the many arguments, let them

simmer, and after a long time turn your preferences into convictions."

Second, and more basic, to keep options open until circumstances make

change necessary. There is enormous inertia a tyranny of the status quoin

private and especially governmental arrangements. Only a crisis actual or

perceived produces real change. When that crisis occurs, the actions that are

taken depend on the ideas that are lying around. That, I believe, is our basic

function: to develop alternatives to existing policies, to keep them alive and

available until the politically impossible becomes politically inevitable.

A personal story will perhaps make my point. Sometime in the late 1960s I

engaged in a debate at the University of Wisconsin with Leon Keyserling, an

unreconstructed collectivist. His clinching blow, as he thought, was to make fun

of my views as utterly reactionary, and he chose to do so by reading, from the

end of chapter 2 of this book, the list of items that, I said, "cannot, so far as I

can see, validly be justified in terms of the principles outlined above." He was

doing very well with the audience of students as he went through my castigation

of price supports, tariffs, and so on, until he came to point 11, "Conscription to

man the military services in peacetime." That expression of my opposition to the

draft brought ardent applause and lost him the audience and the debate.

Incidentally, the draft is the only item on my list of fourteen unjustified

government activities that has so far been eliminated and that victory is by no

means final. In respect of many of the other items, we have moved still farther

away from the principles espoused in this book which is, on one hand, a reason

why the climate of opinion has changed and, on the other, evidence that that

change has so far had little practical effect. Evidence also that the fundamental

thrust of this book is as pertinent to 1981 as to 1962, even though some

examples and details may be outdated.

Commentary, April 1978, pp. 2971.

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Preface

This book is a long-delayed product of a series of lectures that I gave in

June, 1956 at a conference at Wabash College directed by John Van Sickle and

Benjamin Rogge and sponsored by the Volker Foundation. I n subsequent years, I

have given similar lectures at Volker conferences directed by Arthur Kemp, at

Claremont College, directed by Clarence Philbrook, at the University of North

Carolina, and directed by Richard Leftwich, at Oklahoma State University. In

each case I covered the contents of the first two chapters of this book, dealing

with principles, and then applied the principles to a varied set of special

problems.

I am indebted to the directors of these conferences not only for inviting

me to give the lectures, but even more for their criticisms and comments on

them and for friendly pressure to write them up in tentative form, and to Richard

Cornuelle, Kenneth Templeton, and Ivan Bierly of the Volker Foundation who

were responsible for arranging the conferences. I am indebted also to the

participants who, by their incisive probing and deep interest in the issues, and

unquenchable intellectual enthusiasm, forced me to rethink many points and to

correct many errors. This series of conferences stands out as among the most

stimulating intellectual experiences of my life. Needless to say, there is probably

not one of the directors of the conferences or participants in them who agrees

with everything in this book. But I trust they will not be unwilling to assume

some of the responsibility for it.

I owe the philosophy expressed in this book and much of its detail to

many teachers, colleagues, and friends, above all to a distinguished group I have

been privileged to be associated with at the University of Chicago: Frank H.

Knight, Henry C. Simons, Lloyd W. Mints, Aaron Director, Friedrich A. Hayek,

George J. Stigler. I ask their pardon for my failure to acknowledge specifically

the many ideas of theirs which they will find expressed in this book. I have

learned so much from them and what I have learned has become so much a part

of my own thought that I would not know how to select points to footnote.

I dare not try to list the many others to whom I am indebted, lest I do

some an injustice by inadvertently omitting their names. But I cannot refrain

from mentioning my children, Janet and David, whose willingness to accept

nothing on faith has forced me to express technical matters in simple language

and thereby improved both my understanding of the points and, hopefully, my

exposition. I hasten to add that they too accept only responsibility, not identity

of views.

I have drawn freely from material already published. Chapter I is a

revision of material published earlier under the title used for this book in Felix

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Morley (ed.), Essays in Individuality (University of Pennsylvania Press, 1958) and

in still a different form under the same title in The New Individualist Review, Vol.

I, No. I (April, 1961). Chapter vi is a revision of an article by the same title first

published in Robert A. Solo (ed.), Economics and the Public Interest (Rutgers

University Press, 1955). Bits and pieces of other chapters have been taken from

various of my articles and books.

The refrain, "But for my wife, this book would not have been written," has

become a commonplace in academic prefaces. In this case, it happens to be the

literal truth. She pieced together the scraps of the various lectures, coalesced

different versions, translated lectures into something more closely approaching

written English, and has throughout been the driving force in getting the book

finished. The acknowledgment on the title page is an understatement.

My secretary, Muriel A. Porter, has been an efficient and dependable

resource in time of need, and I am very much in her debt. She typed most of the

manuscript as well as many earlier drafts of part of it.

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I ntroduction

In a much quoted passage in his inaugural address, President Kennedy

said, "Ask not what your country can do for you ask what you can do for your

country." It is a striking sign of the temper of our times that the controversy

about this passage centered on its origin and not on its content. Neither half of

the statement expresses a relation between the citizen and his government that

is worthy of the ideals of free men in a free society. The paternalistic "what your

country can do for you" implies that government is the patron, the citizen the

ward, a view that is at odds with the free man's belief in his own responsibility

for his own destiny. The organismic, "what you can do for your country" implies

that government is the master or the deity, the citizen, the servant or the votary.

To the free man, the country is the collection of individuals who compose it, not

something over and above them. He is proud of a common heritage and loyal to

common traditions. But he regards government as a means, an instrumentality,

neither a grantor of favors and gifts, nor a master or god to be blindly

worshipped and served. He recognizes no national goal except as it is the

consensus of the goals that the citizens severally serve. He recognizes no

national purpose except as it is the consensus of the purposes for which the

citizens severally strive.

The free man will ask neither what his country can do for him nor what he

can do for his country. He will ask rather "What can I and my compatriots do

through government" to help us discharge our individual responsibilities, to

achieve our several goals and purposes, and above all, to protect our freedom?

And he will accompany this question with another: How can we keep the

government we create from becoming a Frankenstein that will destroy the very

freedom we establish it to protect? Freedom is a rare and delicate plant. Our

minds tell us, and history confirms, that the great threat to freedom is the

concentration of power. Government is necessary to preserve our freedom, it is

an instrument through which we can exercise our freedom; yet by concentrating

power in political hands, it is also a threat to freedom. Even though the men who

wield this power initially be of good will and even though they be not corrupted

by the power they exercise, the power will both attract and form men of a

different stamp.

How can we benefit from the promise of government while avoiding the

threat to freedom? Two broad principles embodied in our Constitution give an

answer that has preserved our freedom so far, though they have been violated

repeatedly in practice while proclaimed as precept.

First, the scope of government must be limited. Its major function must

be to protect our freedom both from the enemies outside our gates and from our

fellow-citizens: to preserve law and order, to enforce private contracts, to foster

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competitive markets. Beyond this major function, government may enable us at

times to accomplish jointly what we would find it more difficult or expensive to

accomplish severally. However, any such use of government is fraught with

danger. We should not and cannot avoid using government in this way. But there

should be a clear and large balance of advantages before we do. By relying

primarily on voluntary co-operation and private enterprise, in both economic and

other activities, we can insure that the private sector is a check on the powers of

the governmental sector and an effective protection of freedom of speech, of

religion, and of thought.

The second broad principle is that government power must be dispersed.

If government is to exercise power, better in the county than in the state, better

in the state than in Washington. If I do not like what my local community does,

be it in sewage disposal, or zoning, or schools, I can move to another local

community, and though few may take this step, the mere possibility acts as a

check. If I do not like what my state does, I can move to another. If I do not like

what Washington imposes, I have few alternatives in this world of jealous

nations.

The very difficulty of avoiding the enactments of the federal government

is of course the great attraction of centralization to many of its proponents. It

will enable them more effectively, they believe, to legislate programs that as they

see it are in the interest of the public, whether it be the transfer of income from

the rich to the poor or from private to governmental purposes. They are in a

sense right. But this coin has two sides. The power to do good is also the power

to do harm; those who control the power today may not tomorrow; and, more

important, what one man regards as good, another may regard as harm. The

great tragedy of the drive to centralization, as of the drive to extend the scope of

government in general, is that it is mostly led by men of good will who will be

the first to rue its consequences.

The preservation of freedom is the protective reason for limiting and

decentralizing governmental power. But there is also a constructive reason. The

great advances of civilization, whether in architecture or painting, in science or

literature, in industry or agriculture, have never come from centralized

government. Columbus did not set out to seek a new route to China in response

to a majority directive of a parliament, though he was partly financed by an

absolute monarch. Newton and Leibnitz; Einstein and Bohr; Shakespeare, Milton,

and Pasternak; Whitney, McCormick, Edison, and Ford; Jane Addams, Florence

Nightingale, and Albert Schweitzer; no one of these opened new frontiers in

human knowledge and understanding, in literature, in technical possibilities, or in

the relief of human misery in response to governmental directives. Their

achievements were the product of individual genius, of strongly held minority

views, of a social climate permitting variety and diversity.

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Government can never duplicate the variety and diversity of individual

action. At any moment in time, by imposing uniform standards in housing, or

nutrition, or clothing, government could undoubtedly improve the level of living

of many individuals; by imposing uniform standards in schooling, road

construction, or sanitation, central government could undoubtedly improve the

level of performance in many local areas and perhaps even on the average of all

communities. But in the process, government would replace progress by

stagnation, it would substitute uniform mediocrity for the variety essential for

that experimentation which can bring tomorrow's laggards above today's mean.

This book discusses some of these great issues. Its major theme is the

role of competitive capitalism the organization of the bulk of economic activity

through private enterprise operating in a free market as a system of economic

freedom and a necessary condition for political freedom. Its minor theme is the

role that government should play in a society dedicated to freedom and relying

primarily on the market to organize economic activity.

The first two chapters deal with these issues on an abstract level, in terms

of principles rather than concrete application. The later chapters apply these

principles to a variety of particular problems.

An abstract statement can conceivably be complete and exhaustive,

though this ideal is certainly far from realized in the two chapters that follow.

The application of the principles cannot even conceivably be exhaustive. Each

day brings new problems and new circumstances. That is why the role of the

state can never be spelled out once and for all in terms of specific functions. It is

also why we need from time to time to re-examine the bearing of what we hope

are unchanged principles on the problems of the day. A by-product is inevitably a

retesting of the principles and a sharpening of our understanding of them.

It is extremely convenient to have a label for the political and economic

viewpoint elaborated in this book. The rightful and proper label is liberalism.

Unfortunately, "As a supreme, if unintended compliment, the enemies of the

system of private enterprise have thought it wise to appropriate its label", 1 so

that liberalism has, in the United States, come to have a very different meaning

than it did in the nineteenth century or does today over much of the Continent of

Europe.

As it developed in the late eighteenth and early nineteenth centuries, the

intellectual movement that went under the name of liberalism emphasized

freedom as the ultimate goal and the individual as the ultimate entity in the

society. It supported laissez faire at home as a means of reducing the role of the

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state in economic affairs and thereby enlarging the role of the individual; it

supported free trade abroad as a means of linking the nations of the world

together peacefully and democratically. In political matters, it supported the

development of representative government and of parliamentary institutions,

reduction in the arbitrary power of the state, and protection of the civil freedoms

of individuals.

Beginning in the late nineteenth century, and especially after 1930 in the

United States, the term liberalism came to be associated with a very different

emphasis, particularly in economic policy. It came to be associated with a

readiness to rely primarily on the state rather than on private voluntary

arrangements to achieve objectives regarded as desirable. The catchwords

became welfare and equality rather than freedom. The nineteenth-century liberal

regarded an extension of freedom as the most effective way to promote welfare

and equality; the twentieth-century liberal regards welfare and equality as either

prerequisites of or alternatives to freedom. In the name of welfare and equality,

the twentieth-century liberal has come to favor a revival of the very policies of

state intervention and paternalism against which classical liberalism fought. In

the very act of turning the clock back to seventeenth-century mercantilism, he is

fond of castigating true liberals as reactionary!

The change in the meaning attached to the term liberalism is more

striking in economic matters than in political. The twentieth-century liberal, like

the nineteenth-century liberal, favors parliamentary institutions, representative

government, civil rights, and so on. Yet even in political matters, there is a

notable difference. Jealous of liberty, and hence fearful of centralized power,

whether in governmental or private hands, the nineteenth-century liberal favored

political decentralization. Committed to action and confident of the beneficence

of power so long as it is in the hands of a government ostensibly controlled by

the electorate, the twentieth-century liberal favors centralized government. He

will resolve any doubt about where power should be located in favor of the state

instead of the city, of the federal government instead of the state, and of a world

organization instead of a national government.

Because of the corruption of the term liberalism, the views that formerly

went under that name are now often labeled conservatism. But this is not a

satisfactory alternative. The nineteenth-century liberal was a radical, both in the

etymological sense of going to the root of the matter, and in the political sense

of favoring major changes in social institutions. So too must be his modern heir.

We do not wish to conserve the state interventions that have interfered so

greatly with our freedom, though, of course, we do wish to conserve those that

have promoted it, Moreover, in practice, the term conservatism has come to

cover so wide a range of views, and views so incompatible with one another,

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that we shall no doubt see the growth of hyphenated designations, such as

libertarian-conservative and arisTOCratic-conservative.

Partly because of my reluctance to surrender the term to proponents of

measures that would destroy liberty, partly because I cannot find a better

alternative, I shall resolve these difficulties by using the word liberalism in its

original sense as the doctrines pertaining to a free man.

1 Joseph Schumpeter, History of Economic Analysis (New York: Oxford University

Press, 1954) p. 394.

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Chapter I

The Relation between Economic Freedom and

Political Freedom

It is widely believed that politics and economics are separate and largely

unconnected; that individual freedom is a political problem and material welfare

an economic problem; and that any kind of political arrangements can be

combined with any kind of economic arrangements. The chief contemporary

manifestation of this idea is the advocacy of "democratic socialism" by many who

condemn out of hand the restrictions on individual freedom imposed by

"totalitarian socialism" in Russia, and who are persuaded that it is possible for a

country to adopt the essential features of Russian economic arrangements and

yet to ensure individual freedom through political arrangements. The thesis

of this chapter is that such a view is a delusion, that there is an intimate

connection between economics and politics, that only certain combinations of

political and economic arrangements are possible, and that in particular, a

society which is socialist cannot also be democratic, in the sense of guaranteeing

individual freedom.

Economic arrangements play a dual role in the promotion of a free

society. On the one hand, freedom in economic arrangements is itself a

component of freedom broadly understood, so economic freedom is an end in

itself. In the second place, economic freedom is also an indispensable means

toward the achievement of political freedom.

The first of these roles of economic freedom needs special emphasis

because intellectuals in particular have a strong bias against regarding this

aspect of freedom as important. They tend to express contempt for what they

regard as material aspects of life, and to regard their own pursuit of allegedly

higher values as on a different plane of significance and as deserving of special

attention. For most citizens of the country, however, if not for the intellectual,

the direct importance of economic freedom is at least comparable in significance

to the indirect importance of economic freedom as a means to political freedom.

The citizen of Great Britain, who after World War II was not permitted to

spend his vacation in the United States because of exchange control, was being

deprived of an essential freedom no less than the citizen of the United States,

who was denied the opportunity to spend his vacation in Russia because of his

political views. The one was ostensibly an economic limitation on freedom and

the other a political limitation, yet there is no essential difference between the

two.

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The citizen of the United States who is compelled by law to devote

something like 10 per cent of his income to the purchase of a particular kind of

retirement contract, administered by the government, is being deprived of a

corresponding part of his personal freedom. How strongly this deprivation may

be felt and its closeness to the deprivation of religious freedom, which all would

regard as "civil" or "political" rather than "economic", were dramatized by an

episode involving a group of farmers of the Amish sect. On grounds of principle,

this group regarded compulsory federal old age programs as an infringement of

their personal individual freedom and refused to pay taxes or accept benefits. As

a result, some of their livestock were sold by auction in order to satisfy claims for

social security levies. True, the number of citizens who regard compulsory old

age insurance as a deprivation of freedom may be few, but the believer in

freedom has never counted noses.

A citizen of the United States who under the laws of various states is not

free to follow the occupation of his own choosing unless he can get a license for

it, is likewise being deprived of an essential part of his freedom. So is the man

who would like to exchange some of his goods with, say, a Swiss for a watch but

is prevented from doing so by a quota. So also is the Californian who was thrown

into jail for selling Alka Seltzer at a price below that set by the manufacturer

under so-called "fair trade" laws. So also is the farmer who cannot grow the

amount of wheat he wants. And so on. Clearly, economic freedom, in and of

itself, is an extremely important part of total freedom.

Viewed as a means to the end of political freedom, economic

arrangements are important because of their effect on the concentration or

dispersion of power. The kind of economic organization that provides economic

freedom directly, namely, competitive capitalism, also promotes political freedom

because it separates economic power from political power and in this way

enables the one to offset the other.

Historical evidence speaks with a single voice on the relation between

political freedom and a free market. I know of no example in time or place of a

society that has been marked by a large measure of political freedom, and that

has not also used something comparable to a free market to organize the bulk of

economic activity.

Because we live in a largely free society, we tend to forget how limited is

the span of time and the part of the globe for which there has ever been

anything like political freedom: the typical state of mankind is tyranny, servitude,

and misery. The nineteenth century and early twentieth century in the Western

world stand out as striking exceptions to the general trend of historical

development. Political freedom in this instance clearly came along with the free

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market and the development of capitalist institutions. So also did political

freedom in the golden age of Greece and in the early days of the Roman era.

History suggests only that capitalism is a necessary condition for political

freedom. Clearly it is not a sufficient condition. Fascist Italy and Fascist Spain,

Germany at various times in the last seventy years, Japan before World Wars I

and II, tzarist Russia in the decades before World War I are all societies that

cannot conceivably be described as politically free. Yet, in each, private

enterprise was the dominant form of economic organization. It is therefore

clearly possible to have economic arrangements that are fundamentally capitalist

and political arrangements that are not free.

Even in those societies, the citizenry had a good deal more freedom than

citizens of a modern totalitarian state like Russia or Nazi Germany, in which

economic totalitarianism is combined with political totalitarianism. Even in Russia

under the Tzars, it was possible for some citizens, under some circumstances, to

change their jobs without getting permission from political authority because

capitalism and the existence of private property provided some check to the

centralized power of the state.

The relation between political and economic freedom is complex and by

no means unilateral. In the early nineteenth century, Bentham and the

Philosophical Radicals were inclined to regard political freedom as a means to

economic freedom. They believed that the masses were being hampered by the

restrictions that were being imposed upon them, and that if political reform gave

the bulk of the people the vote, they would do what was good for them, which

was to vote for laissez faire. In retrospect, one cannot say that they were wrong.

There was a large measure of political reform that was accompanied by

economic reform in the direction of a great deal of laissez faire. An enormous

increase in the well-being of the masses followed this change in economic

arrangements.

The triumph of Benthamite liberalism in nineteenth-century England was

followed by a reaction toward increasing intervention by government in economic

affairs. This tendency to collectivism was greatly accelerated, both in England

and elsewhere, by the two World Wars. Welfare rather than freedom became the

dominant note in democratic countries. Recognizing the implicit threat to

individualism, the intellectual descendants of the Philosophical Radicals Dicey,

Mises, Hayek, and Simons, to mention only a few feared that a continued

movement toward centralized control of economic activity would prove The Road

to Serfdom, as Hayek entitled his penetrating analysis of the process. Their

emphasis was on economic freedom as a means toward political freedom.

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Events since the end of World War II display still a different relation

between economic and political freedom. Collectivist economic planning has

indeed interfered with individual freedom. At least in some countries, however,

the result has not been the suppression of freedom, but the reversal of economic

policy. England again provides the most striking example. The turning point was

perhaps the "control of engagements" order which, despite great misgivings, the

Labour party found it necessary to impose in order to carry out its economic

policy. Fully enforced and carried through, the law would have involved

centralized allocation of individuals to occupations. This conflicted so sharply with

personal liberty that it was enforced in a negligible number of cases, and then

repealed after the law had been in effect for only a short period. Its repeal

ushered in a decided shift in economic policy, marked by reduced reliance on

centralized "plans" and "programs", by the dismantling of many controls, and by

increased emphasis on the private market. A similar shift in policy occurred in

most other democratic countries.

The proximate explanation of these shifts in policy is the limited success

of central planning or its outright failure to achieve stated objectives. However,

this failure is itself to be attributed, at least in some measure, to the political

implications of central planning and to an unwillingness to follow out its logic

when doing so requires trampling rough-shod on treasured private rights. It may

well be that the shift is only a temporary interruption in the collectivist trend of

this century. Even so, it illustrates the close relation between political freedom

and economic arrangements.

Historical evidence by itself can never be convincing. Perhaps it was sheer

coincidence that the expansion of freedom occurred at the same time as the

development of capitalist and market institutions. Why should there be a

connection? What are the logical links between economic and political freedom?

In discussing these questions we shall consider first the market as a direct

component of freedom, and then the indirect relation between market

arrangements and political freedom. A by-product will be an outline of the ideal

economic arrangements for a free society.

As liberals, we take freedom of the individual, or perhaps the family, as

our ultimate goal in judging social arrangements. Freedom as a value in this

sense has to do with the interrelations among people; it has no meaning

whatsoever to a Robinson Crusoe on an isolated island (without his Man Friday).

Robinson Crusoe on his island is subject to "constraint," he has limited "power,"

and he has only a limited number of alternatives, but there is no problem of

freedom in the sense that is relevant to our discussion. Similarly, in a society

freedom has nothing to say about what an individual does with his freedom; it is

not an all-embracing ethic. Indeed, a major aim of the liberal is to leave the

ethical problem for the individual to wrestle with. The "really" important ethical

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problems are those that face an individual in a free society what he should do

with his freedom. There are thus two sets of values that a liberal will emphasize

the values that are relevant to relations among people, which is the context in

which he assigns first priority to freedom; and the values that are relevant to the

individual in the exercise of his freedom, which is the realm of individual ethics

and philosophy.

The liberal conceives of men as imperfect beings. He regards the problem

of social organization to be as much a negative problem of preventing "bad"

people from doing harm as of enabling "good" people to do good; and, of

course, "bad" and "good" people may be the same people, depending on who is

judging them.

The basic problem of social organization is how to co-ordinate the

economic activities of large numbers of people. Even in relatively backward

societies, extensive division of labor and specialization of function is required to

make effective use of available resources. In advanced societies, the scale on

which coordination is needed, to take full advantage of the opportunities offered

by modern science and technology, is enormously greater. Literally millions of

people are involved in providing one another with their daily bread, let alone with

their yearly automobiles. The challenge to the believer in liberty is to reconcile

this widespread interdependence with individual freedom.

Fundamentally, there are only two ways of co-ordinating the economic

activities of millions. One is central direction involving the use of coercion the

technique of the army and of the modern totalitarian state. The other is

voluntary co-operation of individuals the technique of the market place.

The possibility of co-ordination through voluntary co-operation rests on

the elementary yet frequently denied proposition that both parties to an

economic transaction benefit from it, provided the transaction is bi-laterally

voluntary and informed.

Exchange can therefore bring about co-ordination without coercion. A

working model of a society organized through voluntary exchange is a free

private enterprise exchange economy what we have been calling competitive

capitalism.

In its simplest form, such a society consists of a number of independent

households a collection of Robinson Crusoes, as it were. Each household uses

the resources it controls to produce goods and services that it exchanges for

goods and services produced by other households, on terms mutually acceptable

to the two parties to the bargain. It is thereby enabled to satisfy its wants

indirectly by producing goods and services for others, rather than directly by

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producing goods for its own immediate use. The incentive for adopting this

indirect route is, of course, the increased product made possible by division of

labor and specialization of function. Since the household always has the

alternative of producing directly for itself, it need not enter into any exchange

unless it benefits from it. Hence, no exchange will take place unless both parties

do benefit from it. Co-operation is thereby achieved without coercion.

Specialization of function and division of labor would not go far if the

ultimate productive unit were the household. In a modern society, we have gone

much farther. We have introduced enterprises which are intermediaries between

individuals in their capacities as suppliers of service and as purchasers of goods.

And similarly, specialization of function and division of labor could not go very far

if we had to continue to rely on the barter of product for product. In

consequence, money has been introduced as a means of facilitating exchange,

and of enabling the acts of purchase and of sale to be separated into two parts.

Despite the important role of enterprises and of money in our actual

economy, and despite the numerous and complex problems they raise, the

central characteristic of the market technique of achieving co-ordination is fully

displayed in the simple exchange economy that contains neither enterprises nor

money. As in that simple model, so in the complex enterprise and money-

exchange economy, co-operation is strictly individual and voluntary provided: (a)

that enterprises are private, so that the ultimate contracting parties are

individuals and (b) that individuals arc effectively free to enter or not to enter

into any particular exchange, so that every transaction is strictly voluntary.

It is far easier to state these provisos in general terms than to spell them

out in detail, or to specify precisely the institutional arrangements most

conducive to their maintenance. Indeed, much of technical economic literature is

concerned with precisely these questions. The basic requisite is the maintenance

of law and order to prevent physical coercion of one individual by another and to

enforce contracts voluntarily entered into, thus giving substance to "private".

Aside from this, perhaps the most difficult problems arise from monopoly which

inhibits effective freedom by denying individuals alternatives to the particular

exchange and from "neighborhood effects" effects on third parties for which it is

not feasible to charge or recompense them. These problems will be discussed in

more detail in the following chapter.

So long as effective freedom of exchange is maintained, the central

feature of the market organization of economic activity is that it prevents one

person from interfering with another in respect of most of his activities. The

consumer is protected from coercion by the seller because of the presence of

other sellers with whom he can deal. The seller is protected from coercion by the

consumer because of other consumers to whom he can sell. The employee is

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protected from coercion by the employer because of other employers for whom

he can work, and so on. And the market does this impersonally and without

centralized authority.

Indeed, a major source of objection to a free economy is precisely that it

does this task so well. It gives people what they want instead of what a

particular group thinks they ought to want. Underlying most arguments against

the free market is a lack of belief in freedom itself.

The existence of a free market does not of course eliminate the need for

government. On the contrary, government is essential both as a forum for

determining the "rules of the game" and as an umpire to interpret and enforce

the rules decided on. What the market does is to reduce greatly the range of

issues that must be decided through political means, and thereby to minimize the

extent to which government need participate directly in the game. The

characteristic feature of action through political channels is that it tends to

require or enforce substantial conformity. The great advantage of the market, on

the other hand, is that it permits wide diversity. It is, in political terms, a system

of proportional representation. Each man can vote, as it were, for the color of tie

he wants and get it; he does not have to see what color the majority wants and

then, if he is in the minority, submit.

It is this feature of the market that we refer to when we say that the

market provides economic freedom. But this characteristic also has implications

that go far beyond the narrowly economic. Political freedom means the absence

of coercion of a man by his fellow men. The fundamental threat to freedom is

power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a

momentary majority. The preservation of freedom requires the elimination of

such concentration of power to the fullest possible extent and the dispersal and

distribution of whatever power cannot be eliminated a system of checks and

balances. By removing the organization of economic activity from the control of

political authority, the market eliminates this source of coercive power. It enables

economic strength to be a check to political power rather than a reinforcement.

Economic power can be widely dispersed. There is no law of conservation

which forces the growth of new centers of economic strength to be at the

expense of existing centers. Political power, on the other hand, is more difficult

to decentralize. There can be numerous small independent governments. But it is

far more difficult to maintain numerous equipotent small centers of political

power in a single large government than it is to have numerous centers of

economic strength in a single large economy. There can be many millionaires in

one large economy. But can there be more than one really outstanding leader,

one person on whom the energies and enthusiasms of his countrymen are

centered? If the central government gains power, it is likely to be at the expense

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of local governments. There seems to be something like a fixed total of political

power to be distributed. Consequently, if economic power is joined to political

power, concentration seems almost inevitable. On the other hand, if economic

power is kept in separate hands from political power, it can serve as a check and

a counter to political power.

The force of this abstract argument can perhaps best be demonstrated by

example. Let us consider first, a hypothetical example that may help to bring out

the principles involved, and then some actual examples from recent experience

that illustrate the way in which the market works to preserve political freedom.

One feature of a free society is surely the freedom of individuals to

advocate and propagandize openly for a radical change in the structure of the

society so long as the advocacy is restricted to persuasion and does not include

force or other forms of coercion. It is a mark of the political freedom of a

capitalist society that men can openly advocate and work for socialism. Equally,

political freedom in a socialist society would require that men be free to advocate

the introduction of capitalism. How could the freedom to advocate capitalism be

preserved and protected in a socialist society?

I n order for men to advocate anything, they must in the first place be able

to earn a living. This already raises a problem in a socialist society, since all jobs

are under the direct control of political authorities. It would take an act of self-

denial whose difficulty is underlined by experience in the United States after

World War II with the problem of "security" among Federal employees, for a

socialist government to permit its employees to advocate policies directly

contrary to official doctrine.

But let us suppose this act of self-denial to be achieved. For advocacy of

capitalism to mean anything, the proponents must be able to finance their cause

to hold public meetings, publish pamphlets, buy radio time, issue newspapers

and magazines, and so on. How could they raise the funds? There might and

probably would be men in the socialist society with large incomes, perhaps even

large capital sums in the form of government bonds and the like, but these

would of necessity be high public officials. It is possible to conceive of a minor

socialist official retaining his job although openly advocating capitalism. It strains

credulity to imagine the socialist top brass financing such "subversive" activities.

The only recourse for funds would be to raise small amounts from a large

number of minor officials. But this is no real answer. To tap these sources, many

people would already have to be persuaded, and our whole problem is how to

initiate and finance a campaign to do so. Radical movements in capitalist

societies have never been financed this way. They have typically been supported

by a few wealthy individuals who have become persuaded by a Frederick

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Vanderbilt Field, or an Anita McCormick Blaine, or a Corliss Lamont, to mention a

few names recently prominent, or by a Friedrich Engels, to go farther back. This

is a role of inequality of wealth in preserving political freedom that is seldom

noted the role of the patron.

In a capitalist society, it is only necessary to convince a few wealthy

people to get funds to launch any idea, however strange, and there are many

such persons, many independent foci of support. And, indeed, it is not even

necessary to persuade people or financial institutions with available funds of the

soundness of the ideas to be propagated. It is only necessary to persuade them

that the propagation can be financially successful; that the newspaper or

magazine or book or other venture will be profitable. The competitive publisher,

for example, cannot afford to publish only writing with which he personally

agrees; his touchstone must be the likelihood that the market will be large

enough to yield a satisfactory return on his investment.

In this way, the market breaks the vicious circle and makes it possible

ultimately to finance such ventures by small amounts from many people without

first persuading them. There are no such possibilities in the socialist society;

there is only the all-powerful state.

Let us stretch our imagination and suppose that a socialist government is

aware of this problem and is composed of people anxious to preserve freedom.

Could it provide the funds? Perhaps, but it is difficult to see how. It could

establish a bureau for subsidizing subversive propaganda. But how could it

choose whom to support? If it gave to all who asked, it would shortly find itself

out of funds, for socialism cannot repeal the elementary economic law that a

sufficiently high price will call forth a large supply. Make the advocacy of radical

causes sufficiently remunerative, and the supply of advocates will be unlimited.

Moreover, freedom to advocate unpopular causes does not require that

such advocacy be without cost. On the contrary, no society could be stable if

advocacy of radical change were costless, much less subsidized. It is entirely

appropriate that men make sacrifices to advocate causes in which they deeply

believe. Indeed, it is important to preserve freedom only for people who are

willing to practice self-denial, for otherwise freedom degenerates into license and

irresponsibility. What is essential is that the cost of advocating unpopular causes

be tolerable and not prohibitive.

But we are not yet through. In a free market society, it is enough to have

the funds. The suppliers of paper are as willing to sell it to the Daily Worker as to

the Wall Street J ournal. In a socialist society, it would not be enough to have the

funds. The hypothetical supporter of capitalism would have to persuade a

government factory making paper to sell to him, the government printing press

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to print his pamphlets, a government post office to distribute them among the

people, a government agency to rent him a hall in which to talk, and so on.

Perhaps there is some way in which one could overcome these difficulties

and preserve freedom in a socialist society. One cannot say it is utterly

impossible. What is clear, however, is that there are very real difficulties in

establishing institutions that will effectively preserve the possibility of dissent. So

far as I know, none of the people who have been in favor of socialism and also

in favor of freedom have really faced up to this issue, or made even a

respectable start at developing the institutional arrangements that would permit

freedom under socialism. By contrast, it is clear how a free market capitalist

society fosters freedom.

A striking practical example of these abstract principles is the experience

of Winston Churchill. From 1933 to the outbreak of World War II, Churchill was

not permitted to talk over the British radio, which was, of course, a government

monopoly administered by the British Broadcasting Corporation. Here was a

leading citizen of his country, a Member of Parliament, a former cabinet minister,

a man who was desperately trying by every device possible to persuade his

countrymen to take steps to ward off the menace of Hitler's Germany. He was

not permitted to talk over the radio to the British people because the BBC was a

government monopoly and his position was too "controversial".

Another striking example, reported in the January 26, 1959 issue of Time,

has to do with the "Blacklist Fadeout". Says the Time story,

The Oscar-awarding ritual is Hollywood's biggest pitch for dignity, but two

years ago dignity suffered. When one Robert Rich was announced as top writer

for The Brave One, he never stepped forward. Robert Rich was a pseudonym,

masking one of about 150 writers . . . blacklisted by the industry since 1947 as

suspected Communists or fellow travelers. The case was particularly

embarrassing because the Motion Picture Academy had barred any Communist

or Fifth Amendment pleader from Oscar competition. Last week both the

Communist rule and the mystery of Rich's identity were suddenly rescripted.

Rich turned out to be Dalton (Johnny Got His Gun) Trumbo, one of the

original "Hollywood Ten" writers who refused to testify at the 1947 hearings on

Communism in the movie industry. Said producer Frank King, who had stoutly

insisted that Robert Rich was "a young guy in Spain with a beard": "We have an

obligation to our stockholders to buy the best script we can. Trumbo brought us

The Brave One and we bought it". . . .

In effect it was the formal end of the Hollywood black list. For barred

writers, the informal end came long ago. At least 15% of current Hollywood films

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are reportedly written by blacklist members. Said Producer King, "There are

more ghosts in Hollywood than in Forest Lawn. Every company in town has used

the work of blacklisted people. We're just the first to confirm what everybody

knows."

One may believe, as I do, that communism would destroy all of our

freedoms, one may be opposed to it as firmly and as strongly as possible, and

yet, at the same time, also believe that in a free society it is intolerable for a

man to be prevented from making voluntary arrangements with others that are

mutually attractive because he believes in or is trying to promote communism.

His freedom includes his freedom to promote communism. Freedom also, of

course, includes the freedom of others not to deal with him under those

circumstances. The Hollywood blacklist was an unfree act that destroys freedom

because it was a collusive arrangement that used coercive means to prevent

voluntary exchanges. It didn't work precisely because the market made it costly

for people to preserve the blacklist. The commercial emphasis, the fact that

people who are running enterprises have an incentive to make as much money

as they can, protected the freedom of the individuals who were blacklisted by

providing them with an alternative form of employment, and by giving people an

incentive to employ them.

If Hollywood and the movie industry had been government enterprises or

if in England it had been a question of employment by the British Broadcasting

Corporation it is difficult to believe that the "Hollywood Ten" or their equivalent

would have found employment. Equally, it is difficult to believe that under those

circumstances, strong proponents of individualism and private enterprise or

indeed strong proponents of any view other than the status quo would be able to

get employment.

Another example of the role of the market in preserving political freedom,

was revealed in our experience with McCarthyism. Entirely aside from the

substantive issues involved, and the merits of the charges made, what protection

did individuals, and in particular government employees, have against

irresponsible accusations and probings into matters that it went against their

conscience to reveal? Their appeal to the Fifth Amendment would have been a

hollow mockery without an alternative to government employment.

Their fundamental protection was the existence of a private-market

economy in which they could earn a living. Here again, the protection was not

absolute. Many potential private employers were, rightly or wrongly, averse to

hiring those pilloried. It may well be that there was far less justification for the

costs imposed on many of the people involved than for the costs generally

imposed on people who advocate unpopular causes. But the important point is

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that the costs were limited and not prohibitive, as they would have been if

government employment had been the only possibility.

It is of interest to note that a disproportionately large fraction of the

people involved apparently went into the most competitive sectors of the

economy small business, trade, farming where the market approaches most

closely the ideal free market. No one who buys bread knows whether the wheat

from which it is made was grown by a Communist or a Republican, by a

constitutionalist or a Fascist, or, for that matter, by a Negro or a white. This

illustrates how an impersonal market separates economic activities from political

views and protects men from being discriminated against in their economic

activities for reasons that are irrelevant to their productivity whether these

reasons are associated with their views or their color.

As this example suggests, the groups in our society that have the most at

stake in the preservation and strengthening of competitive capitalism are those

minority groups which can most easily become the object of the distrust and

enmity of the majority the Negroes, the Jews, the foreign-born, to mention only

the most obvious. Yet, paradoxically enough, the enemies of the free market the

Socialists and Communists have been recruited in disproportionate measure from

these groups. Instead of recognizing that the existence of the market has

protected them from the attitudes of their fellow countrymen, they mistakenly

attribute the residual discrimination to the market.

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Chapter 1 1

The Role of Government in a Free Society

A common objection to totalitarian societies is that they regard the end as

justifying the means. Taken literally, this objection is clearly illogical. If the end

does not justify the means, what does? But this easy answer does not dispose of

the objection; it simply shows that the objection is not well put. To deny that the

end justifies the means is indirectly to assert that the end in question is not the

ultimate end, that the ultimate end is itself the use of the proper means.

Desirable or not, any end that can be attained only by the use of bad means

must give way to the more basic end of the use of acceptable means.

To the liberal, the appropriate means are free discussion and voluntary

co-operation, which implies that any form of coercion is inappropriate. The ideal

is unanimity among responsible individuals achieved on the basis of free and full

discussion. This is another way of expressing the goal of freedom emphasized in

the preceding chapter.

From this standpoint, the role of the market, as already noted, is that it

permits unanimity without conformity; that it is a system of effectively

proportional representation. On the other hand, the characteristic feature of

action through explicitly political channels is that it tends to require or to enforce

substantial conformity. The typical issue must be decided "yes" or "no"; at most,

provision can be made for a fairly limited number of alternatives. Even the use of

proportional representation in its explicitly political form does not alter this

conclusion. The number of separate groups that can in fact be represented is

narrowly limited, enormously so by comparison with the proportional

representation of the market. More important, the fact that the final outcome

generally must be a law applicable to all groups, rather than separate legislative

enactments for each "party" represented, means that proportional representation

in its political version, far from permitting unanimity without conformity, tends

toward ineffectiveness and fragmentation. It thereby operates to destroy any

consensus on which unanimity with conformity can rest.

There are clearly some matters with respect to which effective

proportional representation is impossible. I cannot get the amount of national

defense I want and you, a different amount. With respect to such indivisible

matters we can discuss, and argue, and vote. But having decided, we must

conform. It is precisely the existence of such indivisible matters protection of the

individual and the nation from coercion are clearly the most basic that prevents

exclusive reliance on individual action through the market. If we are to use some

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of our resources for such indivisible items, we must employ political channels to

reconcile differences.

The use of political channels, while inevitable, tends to strain the social

cohesion essential for a stable society. The strain is least if agreement for joint

action need be reached only on a limited range of issues on which people in any

event have common views. Every extension of the range of issues for which

explicit agreement is sought strains further the delicate threads that hold society

together. If it goes so far as to touch an issue on which men feel deeply yet

differently, it may well disrupt the society. Fundamental differences in basic

values can seldom if ever be resolved at the ballot box; ultimately they can only

be decided, though not resolved, by conflict. The religious and civil wars of

history are a bloody testament to this judgment.

The widespread use of the market reduces the strain on the social fabric

by rendering conformity unnecessary with respect to any activities it

encompasses. The wider the range of activities covered by the market, the fewer

are the issues on which explicitly political decisions are required and hence on

which it is necessary to achieve agreement. In turn, the fewer the issues on

which agreement is necessary, the greater is the likelihood of getting agreement

while maintaining a free society.

Unanimity is, of course, an ideal. In practice, we can afford neither the

time nor the effort that would be required to achieve complete unanimity on

every issue. We must perforce accept something less. We are thus led to accept

majority rule in one form or another as an expedient. That majority rule is an

expedient rather than itself a basic principle is clearly shown by the fact that our

willingness to resort to majority rule, and the size of the majority we require,

themselves depend on the seriousness of the issue involved. If the matter is of

little moment and the minority has no strong feelings about being overruled, a

bare plurality will suffice. On the other hand, if the minority feels strongly about

the issue involved, even a bare majority will not do. Few of us would be willing

to have issues of free speech, for example, decided by a bare majority. Our legal

structure is full of such distinctions among kinds of issues that require different

kinds of majorities. At the extreme are those issues embodied in the

Constitution. These are the principles that are so important that we are willing to

make minimal concessions to expediency. Something like essential consensus

was achieved initially in accepting them, and we require something like essential

consensus for a change in them.

The self-denying ordinance to refrain from majority rule on certain kinds

of issues that is embodied in our Constitution and in similar written or unwritten

constitutions elsewhere, and the specific provisions in these constitutions or their

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equivalents prohibiting coercion of individuals, are themselves to be regarded as

reached by free discussion and as reflecting essential unanimity about means.

I turn now to consider more specifically, though still in very broad terms,

what the areas are that cannot be handled through the market at all, or can be

handled only at so great a cost that the use of political channels may be

preferable.

Government as Rule-Maker and Umpire

It is important to distinguish the day-to-day activities of people from the

general customary and legal framework within which these take place. The day-

to-day activities are like the actions of the participants in a game when they are

playing it; the framework, like the rules of the game they play. And just as a

good game requires acceptance by the players both of the rules and of the

umpire to interpret and enforce them, so a good society requires that its

members agree on the general conditions that will govern relations among them,

on some means of arbitrating different interpretations of these conditions, and

on some device for enforcing compliance with the generally accepted rules. As in

games, so also in society, most of the general conditions are the unintended

outcome of custom, accepted unthinkingly. At most, we consider explicitly only

minor modifications in them, though the cumulative effect of a series of minor

modifications may be a drastic alteration in the character of the game or of the

society. In both games and society also, no set of rules can prevail unless most

participants most of the time conform to them without external sanctions; unless

that is, there is a broad underlying social consensus. But we cannot rely on

custom or on this consensus alone to interpret and to enforce the rules; we need

an umpire. These then are the basic roles of government in a free society: to

provide a means whereby we can modify the rules, to mediate differences

among us on the meaning of the rules, and to enforce compliance with the rules

on the part of those few who would otherwise not play the game.

The need for government in these respects arises because absolute

freedom is impossible. However attractive anarchy may be as a philosophy, it is

not feasible in a world of imperfect men.

Men's freedoms can conflict, and when they do, one man's freedom must

be limited to preserve another's as a Supreme Court Justice once put it, "My

freedom to move my fist must be limited by the proximity of your chin."

The major problem in deciding the appropriate activities of government is

how to resolve such conflicts among the freedoms of different individuals. In

some cases, the answer is easy. There is little difficulty in attaining near

unanimity to the proposition that one man's freedom to murder his neighbor

must be sacrificed to preserve the freedom of the other man to live. In other

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cases, the answer is difficult. In the economic area, a major problem arises in

respect of the conflict between freedom to combine and freedom to compete.

What meaning is to be attributed to "free" as modifying "enterprise"? In the

United States, "free" has been understood to mean that anyone is free to set up

an enterprise, which means that existing enterprises are not free to keep out

competitors except by selling a better product at the same price or the same

product at a lower price. In the continental tradition, on the other hand, the

meaning has generally been that enterprises are free to do what they want,

including the fixing of prices, division of markets, and the adoption of other

techniques to keep out potential competitors. Perhaps the most difficult specific

problem in this area arises with respect to combinations among laborers, where

the problem of freedom to combine and freedom to compete is particularly

acute.

A still more basic economic area in which the answer is both difficult and

important is the definition of property rights. The notion of property, as it has

developed over centuries and as it is embodied in our legal codes, has become

so much a part of us that we tend to take it for granted, and fail to recognize the

extent to which just what constitutes property and what rights the ownership of

property confers are complex social creations rather than self-evident

propositions. Does my having title to land, for example, and my freedom to use

my property as I wish, permit me to deny to someone else the right to fly over

my land in his airplane? Or does his right to use his airplane take precedence? Or

does this depend on how high he flies? Or how much noise he makes? Does

voluntary exchange require that he pay me for the privilege of flying over my

land? Or that I must pay him to refrain from flying over it? The mere mention of

royalties, copyrights, patents; shares of stock in corporations; riparian rights, and

the like, may perhaps emphasize the role of generally accepted social rules in the

very definition of property. It may suggest also that, in many cases, the

existence of a well specified and generally accepted definition of property is far

more important than just what the definition is.

Another economic area that raises particularly difficult problems is the

monetary system. Government responsibility for the monetary system has long

been recognized. It is explicitly provided for in the constitutional provision which

gives Congress the power "to coin money, regulate the value thereof, and of

foreign coin." There is probably no other area of economic activity with respect

to which government action has been so uniformly accepted. This habitual and

by now almost unthinking acceptance of governmental responsibility makes

thorough understanding of the grounds for such responsibility all the more

necessary, since it enhances the danger that the scope of government will

spread from activities that are, to those that are not, appropriate in a free

society, from providing a monetary framework to determining the allocation of

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resources among individuals. We shall discuss this problem in detail in chapter iii.

In summary, the organization of economic activity through voluntary

exchange presumes that we have provided, through government, for the

maintenance of law and order to prevent coercion of one individual by another,

the enforcement of contracts voluntarily entered into, the definition of the

meaning of property rights, the interpretation and enforcement of such rights,

and the provision of a monetary framework.

Action Through Government on Grounds of Technical Monopoly and

Neighborhood Effects

The role of government just considered is to do something that the

market cannot do for itself, namely, to determine, arbitrate, and enforce the

rules of the game. We may also want to do through government some things

that might conceivably be done through the market but that technical or similar

conditions render it difficult to do in that way. These all reduce to cases in which

strictly voluntary exchange is either exceedingly costly or practically impossible.

There are two general classes of such cases: monopoly and similar market

imperfections, and neighborhood effects.

Exchange is truly voluntary only when nearly equivalent alternatives exist.

Monopoly implies the absence of alternatives and thereby inhibits effective

freedom of exchange. In practice, monopoly frequently, if not generally, arises

from government support or from collusive agreements among individuals. With

respect to these, the problem is either to avoid governmental fostering of

monopoly or to stimulate the effective enforcement of rules such as those

embodied in our anti-trust laws. However, monopoly may also arise because it is

technically efficient to have a single producer or enterprise. I venture to suggest

that such cases are more limited than is supposed but they unquestionably do

arise. A simple example is perhaps the provision of telephone services within a

community. I shall refer to such cases as "technical" monopoly.

When technical conditions make a monopoly the natural outcome of

competitive market forces, there are only three alternatives that seem available:

private monopoly, public monopoly, or public regulation. All three are bad so we

must choose among evils. Henry Simons, observing public regulation of

monopoly in the United States, found the results so distasteful that he concluded

public monopoly would be a lesser evil. Walter Eucken, a noted German liberal,

observing public monopoly in German railroads, found the results so distasteful

that he concluded public regulation would be a lesser evil. Having learned from

both, I reluctantly conclude that, if tolerable, private monopoly may be the least

of the evils.

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If society were static so that the conditions which give rise to a technical

monopoly were sure to remain, I would have little confidence in this solution. In

a rapidly changing society, however, the conditions making for technical

monopoly frequently change and I suspect that both public regulation and public

monopoly are likely to be less responsive to such changes in conditions, to be

less readily capable of elimination, than private monopoly.

Railroads in the United States are an excellent example. A large degree of

monopoly in railroads was perhaps inevitable on technical grounds in the

nineteenth century. This was the justification for the Interstate Commerce

Commission. But conditions have changed. The emergence of road and air

transport has reduced the monopoly element in railroads to negligible

proportions. Yet we have not eliminated the ICC. On the contrary, the ICC, which

started out as an agency to protect the public from exploitation by the railroads,

has become an agency to protect railroads from competition by trucks and other

means of transport, and more recently even to protect existing truck companies

from competition by new entrants. Similarly, in England, when the railroads were

nationalized, trucking was at first brought into the state monopoly. If railroads

had never been subjected to regulation in the United States, it is nearly certain

that by now transportation, including railroads, would be a highly competitive

industry with little or no remaining monopoly elements.

The choice between the evils of private monopoly, public monopoly, and

public regulation cannot, however, be made once and for all, independently of

the factual circumstances. If the technical monopoly is of a service or commodity

that is regarded as essential and if its monopoly power is sizable, even the short

run effects of private unregulated monopoly may not be tolerable, and either

public regulation or ownership may be a lesser evil.

Technical monopoly may on occasion justify a de facto public monopoly. It

cannot by itself justify a public monopoly achieved by making it illegal for anyone

else to compete. For example, there is no way to justify our present public

monopoly of the post office. It may be argued that the carrying of mail is a

technical monopoly and that a government monopoly is the least of evils. Along

these lines, one could perhaps justify a government post office but not the

present law, which makes it illegal for anybody else to carry mail. If the delivery

of mail is a technical monopoly, no one will be able to succeed in competition

with the government. If it is not, there is no reason why the government should

be engaged in it. The only way to find out is to leave other people free to enter.

The historical reason why we have a post office monopoly is because the

Pony Express did such a good job of carrying the mail across the continent that,

when the government introduced transcontinental service, it couldn't compete

effectively and lost money. The result was a law making it illegal for anybody

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else to carry the mail. That is why the Adams Express Company is an investment

trust today instead of an operating company. I conjecture that if entry into the

mail-carrying business were open to all, there would be a large number of firms

entering it and this archaic industry would become revolutionized in short order.

A second general class of cases in which strictly voluntary exchange is

impossible arises when actions of individuals have effects on other individuals for

which it is not feasible to charge or recompense them. This is the problem of

"neighborhood effects".

An obvious example is the pollution of a stream. The man who pollutes a stream

is in effect forcing others to exchange good water for bad. These others might

be willing to make the exchange at a price. But it is not feasible for them, acting

individually, to avoid the exchange or to enforce appropriate compensation.

A less obvious example is the provision of highways. In this case, it is

technically possible to identify and hence charge individuals for their use of the

roads and so to have private operation. However, for general access roads,

involving many points of entry and exit, the costs of collection would be

extremely high if a charge were to be made for the specific services received by

each individual, because of the necessity of establishing toll booths or the

equivalent at all entrances. The gasoline tax is a much cheaper method of

charging individuals roughly in proportion to their use of the roads. This method,

however, is one in which the particular payment cannot be identified closely with

the particular use. Hence, it is hardly feasible to have private enterprise provide

the service and collect the charge without establishing extensive private

monopoly.

These considerations do not apply to long-distance turnpikes with high

density of traffic and limited access. For these, the costs of collection are small

and in many cases are now being paid, and there are often numerous

alternatives, so that there is no serious monopoly problem. Hence, there is every

reason why these should be privately owned and operated. If so owned and

operated, the enterprise running the highway should receive the gasoline taxes

paid on account of travel on it.

Parks are an interesting example because they illustrate the difference

between cases that can and cases that cannot be justified by neighborhood

effects, and because almost everyone at first sight regards the conduct of

National Parks as obviously a valid function of government. In fact, however,

neighborhood effects may justify a city park; they do not justify a national park,

like Yellowstone National Park or the Grand Canyon. What is the fundamental

difference between the two? For the city park, it is extremely difficult to identify

the people who benefit from it and to charge them for the benefits which they

receive. If there is a park in the middle of the city, the houses on all sides get

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the benefit of the open space, and people who walk through it or by it also

benefit. To maintain toll collectors at the gates or to impose annual charges per

window overlooking the park would be very expensive and difficult. The

entrances to a national park like Yellowstone, on the other hand, are few; most

of the people who come stay for a considerable period of time and it is perfectly

feasible to set up toll gates and collect admission charges. This is indeed now

done, though the charges do not cover the whole costs. If the public wants this

kind of an activity enough to pay for it, private enterprises will have every

incentive to provide such parks. And, of course, there are many private

enterprises of this nature now in existence. I cannot myself conjure up any

neighborhood effects or important monopoly effects that would justify

governmental activity in this area.

Considerations like those I have treated under the heading of

neighborhood effects have been used to rationalize almost every conceivable

intervention. In many instances, however, this rationalization is special pleading

rather than a legitimate application of the concept of neighborhood effects.

Neighborhood effects cut both ways. They can be a reason for limiting the

activities of government as well as for expanding them. Neighborhood effects

impede voluntary exchange because it is difficult to identify the effects on third

parties and to measure their magnitude; but this difficulty is present in

governmental activity as well. It is hard to know when neighborhood effects are

sufficiently large to justify particular costs in overcoming them and even harder

to distribute the costs in an appropriate fashion. Consequently, when

government engages in activities to overcome neighborhood effects, it will in

part introduce an additional set of neighborhood effects by failing to charge or to

compensate individuals properly. Whether the original or the new neighborhood

effects are the more serious can only be judged by the facts of the individual

case, and even then, only very approximately. Furthermore, the use of

government to overcome neighborhood effects itself has an extremely important

neighborhood effect which is unrelated to the particular occasion for government

action. Every act of government intervention limits the area of individual freedom

directly and threatens the preservation of freedom indirectly for reasons

elaborated in the first chapter.

Our principles offer no hard and fast line how far it is appropriate to use

government to accomplish jointly what it is difficult or impossible for us to

accomplish separately through strictly voluntary exchange. In any particular case

of proposed intervention, we must make up a balance sheet, listing separately

the advantages and disadvantages. Our principles tell us what items to put on

the one side and what items on the other and they give us some basis for

attaching importance to the different items. In particular, we shall always want

to enter on the liability side of any proposed government intervention, its

neighborhood effect in threatening freedom, and give this effect considerable

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weight. Just how much weight to give to it, as to other items, depends upon the

circumstances. If, for example, existing government intervention is minor, we

shall attach a smaller weight to the negative effects of additional government

intervention. This is an important reason why many earlier liberals, like Henry

Simons, writing at a time when government was small by today's standards,

were willing to have government undertake activities that today's liberals would

not accept now that government has become so overgrown.

Action Through Government on Paternalistic Grounds

Freedom is a tenable objective only for responsible individuals. We do not

believe in freedom for madmen or children. The necessity of drawing a line

between responsible individuals and others is inescapable, yet it means that

there is an essential ambiguity in our ultimate objective of freedom. Paternalism

is inescapable for those whom we designate as not responsible.

The clearest case, perhaps, is that of madmen. We are willing neither to

permit them freedom nor to shoot them. It would be nice if we could rely on

voluntary activities of individuals to house and care for the madmen. But I think

we cannot rule out the possibility that such charitable activities will be

inadequate, if only because of the neighborhood effect involved in the fact that I

benefit if another man contributes to the care of the insane. For this reason, we

may be willing to arrange for their care through government.

Children offer a more difficult case. The ultimate operative unit in our

society is the family, not the individual. Yet the acceptance of the family as the

unit rests in considerable part on expediency rather than principle. We believe

that parents are generally best able to protect their children and to provide for

their development into responsible individuals for whom freedom is appropriate.

But we do not believe in the freedom of parents to do what they will with other

people. The children are responsible individuals in embryo, and a believer in

freedom believes in protecting their ultimate rights.

To put this in a different and what may seem a more callous way, children

are at one and the same time consumer goods and potentially responsible

members of society. The freedom of individuals to use their economic resources

as they want includes the freedom to use them to have children to buy, as it

were, the services of children as a particular form of consumption. But once this

choice is exercised, the children have a value in and of themselves and have a

freedom of their own that is not simply an extension of the freedom of the

parents.

The paternalistic ground for governmental activity is in many ways the

most troublesome to a liberal; for it involves the acceptance of a principle that

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some shall decide for others which he finds objectionable in most applications

and which he rightly regards as a hallmark of his chief intellectual opponents, the

proponents of collectivism in one or another of its guises, whether it be

communism, socialism, or a welfare state. Yet there is no use pretending that

problems are simpler than in fact they are. There is no avoiding the need for

some measure of paternalism. As Dicey wrote in 1914 about an act for the

protection of mental defectives, "The Mental Deficiency Act is the first step along

a path on which no sane man can decline to enter, but which, if too far pursued,

will bring statesmen across difficulties hard to meet without considerable

interference with individual liberty." 1 There is no formula that can tell us where

to stop. We must rely on our fallible judgment and, having reached a judgment,

on our ability to persuade our fellow men that it is a correct judgment, or their

ability to persuade us to modify our views. We must put our faith, here as

elsewhere, in a consensus reached by imperfect and biased men through free

discussion and trial and error.

Conclusion

A government which maintained law and order, defined property rights,

served as a means whereby we could modify property rights and other rules of

the economic game, adjudicated disputes about the interpretation of the rules,

enforced contracts, promoted competition, provided a monetary framework,

engaged in activities to counter technical monopolies and to overcome

neighborhood effects widely regarded as sufficiently important to justify

government intervention, and which supplemented private charity and the

private family in protecting the irresponsible, whether madman or child such a

government would clearly have important functions to perform. The consistent

liberal is not an anarchist.

Yet it is also true that such a government would have clearly limited

functions and would refrain from a host of activities that are now undertaken by

federal and state governments in the United States, and their counterparts in

other Western countries. Succeeding chapters will deal in some detail with some

of these activities, and a few have been discussed above, but it may help to give

a sense of proportion about the role that a liberal would assign government

simply to list, in closing this chapter, some activities currently undertaken by

government in the U.S., that cannot, so far as I can see, validly be justified in

terms of the principles outlined above:

1. Parity price support programs for agriculture.

2. Tariffs on imports or restrictions on exports, such as current oil import

quotas, sugar quotas, etc.

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3. Governmental control of output, such as through the farm program, or

through prorationing of oil as is done by the Texas Railroad Commission.

4. Rent control, such as is still practiced in New York, or more general

price and wage controls such as were imposed during and just after World War

5. Legal minimum wage rates, or legal maximum prices, such as the legal

maximum of zero on the rate of interest that can be paid on demand deposits by

commercial banks, or the legally fixed maximum rates that can be paid on

savings and time deposits.

6. Detailed regulation of industries, such as the regulation of

transportation by the Interstate Commerce Commission. This had some

justification on technical monopoly grounds when initially introduced for

railroads; it has none now for any means of transport. Another example is

detailed regulation of banking.

7. A similar example, but one which deserves special mention because of

its implicit censorship and violation of free speech, is the control of radio and

television by the Federal Communications Commission.

8. Present social security programs, especially the old-age and retirement

programs compelling people in effect (a) to spend a specified fraction of their

income on the purchase of retirement annuity, (b) to buy the annuity from a

publicly operated enterprise.

9. Licensure provisions in various cities and states which restrict particular

enterprises or occupations or professions to people who have a license, where

the license is more than a receipt for a tax which anyone who wishes to enter

the activity may pay.

10. So-called "public-housing" and the host of other subsidy programs

directed at fostering residential construction such as F.H.A. and V.A. guarantee

of mortgage, and the like.

11. Conscription to man the military services in peacetime. The

appropriate free market arrangement is volunteer military forces; which is to say,

hiring men to serve. There is no justification for not paying whatever price is

necessary to attract the required number of men. Present arrangements are

inequitable and arbitrary, seriously interfere with the freedom of young men to

shape their lives, and probably are even more costly than the market alternative.

(Universal military training to provide a reserve for war time is a different

problem and may be justified on liberal grounds.)

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12. National parks, as noted above.

13. The legal prohibition on the carrying of mail for profit.

14. Publicly owned and operated toll roads, as noted above.

This list is far from comprehensive.

1 A. V. Dicey, Lectures on the Relation between Law and Public Opinion in

England during the Nineteenth Century (2d. ed.; London: Macmillan & Co.,

1914), p. li.

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Chapter 1 1 1

The Control of Money

"Full employment" and "economic growth" have in the past few decades

become primary excuses for widening the extent of government intervention in

economic affairs. A private free-enterprise economy, it is said, is inherently

unstable. Left to itself, it will produce recurrent cycles of boom and bust. The

government must therefore step in to keep things on an even keel. These

arguments were particularly potent during and after the Great Depression of the

1930's, and were a major element giving rise to the New Deal in this country and

comparable extensions of governmental intervention in others. More recently,

"economic growth" has become the more popular rallying call. Government must,

it is argued, see to it that the economy expands to provide the wherewithal for

the cold war and demonstrate to the uncommitted nations of the world that a

democracy can grow more rapidly than a communist state.

These arguments are thoroughly misleading. The fact is that the Great

Depression, like most other periods of severe unemployment, was produced by

government mismanagement rather than by any inherent instability of the

private economy. A governmentally established agency the Federal Reserve

System had been assigned responsibility for monetary policy. In 1930 and 1931,

it exercised this responsibility so ineptly as to convert what otherwise would have

been a moderate contraction into a major catastrophe (see further discussion,

pages 4550, below). Similarly today, governmental measures constitute the

major impediments to economic growth in the United States. Tariffs and other

restrictions on international trade, high tax burdens and a complex and

inequitable tax structure, regulatory commissions, government price and wage

fixing, and a host of other measures give individuals an incentive to misuse and

misdirect resources, and distort the investment of new savings. What we

urgently need, for both economic stability and growth, is a reduction of

government intervention not an increase.

Such a reduction would still leave an important role for government in

these areas. It is desirable that we use government to provide a stable monetary

framework for a free economy this is part of the function of providing a stable

legal framework. It is desirable too that we use government to provide a general

legal and economic framework that will enable individuals to produce growth in

the economy, if that is in accord with their values.

The major areas of governmental policy that are relevant to economic

stability are monetary policy and fiscal or budgetary policy. This chapter

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discusses domestic monetary policy, the next, international monetary

arrangements, and chapter v, fiscal or budgetary policy.

Our task in this and the following chapter is to steer a course between

two views, neither of which is acceptable though both have their attractions. The

Scylla is the belief that a purely automatic gold standard is both feasible and

desirable and would resolve all the problems of fostering economic co-operation

among individuals and nations in a stable environment. The Charybdis is the

belief that the need to adapt to unforeseen circumstances requires the

assignment of wide discretionary powers to a group of technicians, gathered

together in an "independent" central bank, or in some bureaucratic body. Neither

has proved a satisfactory solution in the past; and neither is likely to in the

future.

A liberal is fundamentally fearful of concentrated power. His objective is to

preserve the maximum degree of freedom for each individual separately that is

compatible with one man's freedom not interfering with other men's freedom. He

believes that this objective requires that power be dispersed. He is suspicious of

assigning to government any functions that can be performed through the

market, both because this substitutes coercion for voluntary co-operation in the

area in question and because, by giving government an increased role, it

threatens freedom in other areas.

The need for the dispersal of power raises an especially difficult problem

in the field of money. There is widespread agreement that government must

have some responsibility for monetary matters. There is also widespread

recognition that control over money can be a potent tool for controlling and

shaping the economy. Its potency is dramatized in Lenin's famous dictum that

the most effective way to destroy a society is to destroy its money. It is

exemplified in more pedestrian fashion by the extent to which control of money

has, from time immemorial, enabled sovereigns to exact heavy taxes from the

populace at large, very often without the explicit agreement of the legislature

when there has been one. This has been true from early times when monarchs

clipped coins and adopted similar expedients to the present with our more

sophisticated modern techniques for turning the printing press or simply altering

book entries. The problem is to establish institutional arrangements that will

enable government to exercise responsibility for money, yet at the same time

limit the power thereby given to government and prevent this power from being

used in ways that will tend to weaken rather than strengthen a free society.

A Commodity Standard

Historically, the device that has evolved most frequently in many different

places and over the course of centuries is a commodity standard; i.e. , the use as

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money of some physical commodity such as gold or silver, brass or tin, cigarettes

or cognac, or various other goods. If money consisted wholly of a physical

commodity of this type, there would be, in principle, no need for control by the

government at all. The amount of money in society would depend on the cost of

producing the monetary commodity rather than other things. Changes in the

amount of money would depend on changes in the technical conditions of

producing the monetary commodity and on changes in the demand for money.

This is an ideal that animates many believers in an automatic gold standard.

Actual commodity standards have deviated very far from this simple

pattern which requires no governmental intervention. Historically, a commodity

standard such as a gold standard or a silver standard has been accompanied by

the development of fiduciary money of one kind or another, ostensibly

convertible into the monetary commodity on fixed terms. There was a very good

reason for this development. The fundamental defect of a commodity standard,

from the point of view of the society as a whole, is that it requires the use of real

resources to add to the stock of money. People must work hard to dig gold out

of the ground in South African order to rebury it in Fort Knox or some similar

place. The necessity of using real resources for the operation of a commodity

standard establishes a strong incentive for people to find ways to achieve the

same result without employing these resources. If people will accept as money

pieces of paper on which is printed "I promise to pay units of the commodity

standard," these pieces of paper can perform the same function as the physical

pieces of gold or silver, and they require very much less in resources to produce.

This point, which I have discussed at somewhat greater length elsewhere, 1

seems to me the fundamental difficulty with a commodity standard.

If an automatic commodity standard were feasible, it would provide an

excellent solution to the liberal's dilemma: a stable monetary framework without

the danger of the irresponsible exercise of monetary powers. If, for example, an

honest-to-goodness gold standard, in which 100 per cent of the money in a

country consisted literally of gold, were widely backed by the public at large,

imbued with the mythology of a gold standard and with the belief that it is

immoral and improper for government to interfere with its operation, it would

provide an effective guarantee against governmental tinkering with the currency

and against irresponsible monetary action. Under such a standard, any monetary

powers of government would be very minor in scope. But, as just noted, such an

automatic system has historically never proved feasible. It has always tended to

develop in the direction of a mixed system containing fiduciary elements such as

bank notes and deposits, or government notes in addition to the monetary

commodity. And once fiduciary elements have been introduced, it has proved

difficult to avoid governmental control over them, even when they were initially

issued by private individuals. The reason is basically the difficulty of preventing

counterfeiting or its economic equivalent. Fiduciary money is a contract to pay

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standard money. It so happens that there tends to be a long interval between

the making of such a contract and its realization. This enhances the difficulty of

enforcing the contract and hence also the temptation to issue fraudulent

contracts. In addition, once fiduciary elements have been introduced, the

temptation for government itself to issue fiduciary money is almost irresistible. In

practice, therefore, commodity standards have tended to become mixed

standards involving extensive intervention by the state.

It should be noted that despite the great amount of talk by many people

in favor of the gold standard, almost no one today literally desires an honest-to-

goodness, full gold standard. People who say they want a gold standard are

almost invariably talking about the present kind of standard, or the kind of

standard that was maintained in the 1930's; a gold standard managed by a

central bank or other governmental bureau, which holds a small amount of gold

as "backing" to use that very misleading term for fiduciary money. Some do go

so far as to favor the kind of standard maintained in the 1920's, in which there

was literal circulation of gold or gold certificates as hand-to-hand currency a

gold-coin standard but even they favor the coexistence with gold of

governmental fiduciary currency plus deposits issued by banks holding fractional

reserves in either gold or fiduciary currency. Even during the so-called great days

of the gold standard in the nineteenth century, when the Bank of England was

supposedly running the gold standard skillfully, the monetary system was far

from a fully automatic gold standard. Even then it was a highly managed

standard. And certainly the situation is now more extreme as a result of the

adoption by country after country of the view that government has responsibility

for "full employment."

My conclusion is that an automatic commodity standard is neither a

feasible nor a desirable solution to the problem of establishing monetary

arrangements for a free society. It is not desirable because it would involve a

large cost in the form of resources used to produce the monetary commodity. It

is not feasible because the mythology and beliefs required to make it effective do

not exist.

This conclusion is supported not only by the general historical evidence

referred to but also by the specific experience of the United States. From 1879,

when the United States resumed gold payments after the Civil War, to 1913, the

United States was on a gold standard. Though closer to a thoroughly automatic

gold standard than anything we have had since the end of World War I, the gold

standard was still far from a 100 per cent gold standard. There were government

issues of paper money, and private banks issued most of the effective circulating

medium of the country in the form of deposits; the banks were closely regulated

in their operations by governmental agencies national banks by the Comptroller

of the Currency, state banks by state banking authorities. Gold, whether held by

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the Treasury, by banks, or directly by individuals as coins or gold certificates,

accounted for between 10 per cent and 20 per cent of the money stock, the

exact percentage varying from year to year. The remaining 80 per cent to 90 per

cent consisted of silver, fiduciary currency, and bank deposits not matched by

gold reserves.

In retrospect, the system may seem to us to have worked reasonably

well. To Americans of the time, it clearly did not. The agitation over silver in the

1880's, culminating in Bryan's Cross of Gold speech which set the tone for the

1896 election, was one sign of dissatisfaction. In turn, the agitation was largely

responsible for the severely depressed years in the early 1890's. The agitation

led to widespread fears that the United States would go off gold and that hence

the dollar would lose value in terms of foreign currencies. This led to a flight

from the dollar and a capital outflow that forced deflation at home.

Successive financial crises, in 1873, 1884, 1890, and 1893 produced a

widespread demand for banking reform on the part of the business and banking

community. The panic of 1907, involving the concerted refusal by banks to

convert deposits into currency on demand, finally crystallized the feeling of

dissatisfaction with the financial system into an urgent demand for governmental

action. A National Monetary Commission was established by Congress, and its

recommendations, reported in 1910, were embodied in the Federal Reserve Act

passed in 1913. Reforms along the lines of the Federal Reserve Act had the

backing of every section of the community, from the working classes to the

bankers, and of both political parties. The chairman of the National Monetary

Commission was a Republican, Nelson W. Aldrich; the Senator mainly responsible

for the Federal Reserve Act was a Democrat, Carter W. Glass.

The change in monetary arrangements introduced by the Federal Reserve

Act turned out in practice to be far more drastic than was intended by its authors

or its supporters. At the time the Act was passed, a gold standard reigned

supreme throughout the world not a fully automatic gold standard but something

far closer to that ideal than anything we have experienced since. It was taken for

granted that it would continue to do so and thus narrowly limit the powers of the

Federal Reserve System. No sooner was the Act passed than World War I broke

out. There was a large-scale abandonment of the gold standard. By the end of

the war, the Reserve System was no longer a minor adjunct to the gold standard

designed to insure the convertibility of one form of money into others and to

regulate and supervise banks. It had become a powerful discretionary authority

able to determine the quantity of money in the United States and to affect

international financial conditions throughout the world.

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A Discretionary Monetary Authority

The establishment of the Federal Reserve System was the most notable

change in United States monetary institutions since at least the Civil War

National Banking Act. For the first time since the expiration of the charter of the

Second Bank of the United States in 1836, it established a separate official body

charged with explicit responsibility for monetary conditions, and supposedly

clothed with adequate power to achieve monetary stability or, at least, to

prevent pronounced instability. It is therefore instructive to compare experience

as a whole before and after its establishment say, from just after the Civil War to

1914 and from 1914 to date, to take two periods of equal length.

The second period was clearly the more unstable economically, whether

instability is measured by the fluctuations in the stock of money, in prices, or in

output. Partly, the greater instability reflects the effect of two world wars during

the second period; these would clearly have been a source of instability

whatever our monetary system. But even if the war and immediate postwar

years are omitted, and we consider only the peacetime years from, say, 1920

through 1939, and 1947 to date, the result is the same. The stock of money,

prices, and output was decidedly more unstable after the establishment of the

Reserve System than before. The most dramatic period of instability in output

was of course the period between the two wars which includes the severe

contractions of 192021, 192933, and 193738. No other twenty-year period in

American history contains as many as three such severe contractions.

This crude comparison does not of course prove that the Federal Reserve

System failed to contribute to monetary stability. Perhaps the problems that the

System had to handle were more severe than those that impinged on the earlier

monetary structure. Perhaps those problems would have produced an even

greater degree of monetary instability under the earlier arrangements. But the

crude comparison should at least give the reader pause before he takes for

granted, as is so often done, that an agency as long established, as powerful, as

pervasive as the Federal Reserve System is performing a necessary and desirable

function and is contributing to the attainment of the objectives for which it was

established.

I am myself persuaded, on the basis of extensive study of the historical

evidence, that the difference in economic stability revealed by the crude

comparison is in fact attributable to the difference in monetary institutions. This

evidence persuades me that at least a third of the price rise during and just after

World War I is attributable to the establishment of the Federal Reserve System

and would not have occurred if the earlier banking system had been retained;

that the severity of each of the major contractionsl92021, 192933, and 193738is

directly attributable to acts of commission and omission by the Reserve

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authorities and would not have occurred under earlier monetary and banking

arrangements. There might well have been recessions on these or other

occasions, but it is highly unlikely that any would have developed into a major

contraction.

I clearly cannot present this evidence here. 2 However, in view of the

importance which the Great Depression of 192933 played in forming or, I would

say, deforming general attitudes toward the role of government in economic

affairs, it may be worth indicating more fully for this episode the kind of

interpretation suggested by the evidence.

Because of its dramatic character, the stock market crash in October,

1929, which terminated the bull market of 1928 and 1929 is often regarded as

both the start and the major proximate cause of the Great Depression. Neither is

correct. The peak of business was reached in mid-1929, some months prior to

the crash. The peak may well have come as early as it did partly as a result of

relatively tight money conditions imposed by the Federal Reserve System in an

attempt to curb "speculation" in this indirect way, the stock market may have

played a role in bringing about the contraction. The stock market crash in turn

undoubtedly had some indirect effects on business confidence and on the

willingness of individuals to spend which exerted a depressing influence on the

course of business. But by themselves, these effects could not have produced a

collapse in economic activity. At most, they would have made the contraction

somewhat longer and more severe than the usual mild recessions that have

punctuated American economic growth throughout our history; they would not

have made it the catastrophe it was.

For something like the first year, the contraction showed none of those

special features that were to dominate its later course. The economic decline

was more severe than during the first year of most contractions, possibly in

response to the stock market crash plus the unusually tight monetary conditions

that had been maintained since mid-1928. But it showed no qualitatively

different characteristics, no signs of degenerating into a major catastrophe.

Except on naive post hoc ergo propter hoc reasoning, there is nothing in the

economic situation as it stood in, say, September or October, 1930 that made

the continued and drastic decline of the following years inevitable or even highly

probable. In retrospect, it is clear that the Reserve System should already have

been behaving differently than it did, that it should not have allowed the money

stock to decline by nearly 3 per cent from August 1929 to October 1930a larger

decline than during the whole of all but the most severe prior contractions.

Though this was a mistake, it was perhaps excusable, and certainly not critical.

The character of the contraction changed drastically in November 1930,

when a series of bank failures led to widespread runs on banks, which is to say

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attempts by depositors to convert deposits into currency. The contagion spread

from one part of the country to another and reached a climax with the failure on

December 11, 1930 of the Bank of the United States. This failure was critical not

only because the Bank was one of the largest in the country, with over $ 200

million in deposits, but also because, though an ordinary commercial bank, its

name had led many both at home and even more abroad to regard it as

somehow an official bank.

Prior to October, 1930, there had been no sign of a liquidity crisis, or any

loss of confidence in banks. From this time on, the economy was plagued by

recurrent liquidity crises. A wave of bank failures would taper down a while, and

then start up again as a few dramatic failures or other events produced a new

loss of confidence in the banking system and a new series of runs on banks.

These were important not only or even primarily because of the failures of the

banks but because of their effect on the money stock.

In a fractional reserve banking system like ours, a bank does not of

course have a dollar of currency (or its equivalent) for a dollar of deposits. That

is why "deposits" is such a misleading term. When you deposit a dollar of cash in

a bank, the bank may add fifteen or twenty cents to its cash; the rest it will lend

out through another window. The borrower may in turn redeposit it, in this or

another bank, and the process is repeated. The result is that for every dollar of

cash owned by banks, they owe several dollars of deposits. The total stock of

money cash plus deposits for a given amount of cash is therefore higher the

larger the fraction of its money the public is willing to hold as deposits. Any

widespread attempt on the part of depositors to "get their money" must

therefore mean a decline in the total amount of money unless there is some way

in which additional cash can be created and some way for banks to get it.

Otherwise, one bank, in trying to satisfy its depositors, will put pressure on other

banks by calling loans or selling investments or withdrawing its deposits and

these other banks in turn will put pressure on still others. The vicious cycle, if

allowed to proceed, grows on itself as the attempt of banks to get cash forces

down the prices of securities, renders banks insolvent that would otherwise have

been entirely sound, shakes the confidence of depositors, and starts the cycle

over again.

This was precisely the kind of a situation that had led to a banking panic

under the pre-Federal-Reserve banking system, and to a concerted suspension of

the convertibility of deposits into currency, as in 1907. Such a suspension was a

drastic step and for a short while made matters worse. But it was also a

therapeutic measure. It cut short the vicious cycle by preventing the spread of

the contagion, by keeping the failure of a few banks from producing pressure on

other banks and leading to the failure of otherwise sound banks. In a few weeks

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or months, when the situation had stabilized, the suspension could be lifted, and

recovery begin without monetary contraction.

As we have seen, one of the major reasons for establishing the Federal

Reserve System was to deal with such a situation. It was given the power to

create more cash if a widespread demand should arise on the part of the public

for currency instead of deposits, and was given the means to make the cash

available to banks on the security of the bank's assets. In this way, it was

expected that any threatened panic could be averted, that there would be no

need for suspension of convertibility of deposits into currency, and that the

depressing effects of monetary crises could be entirely avoided.

The first need for these powers and hence the first test of their efficacy

came in November and December of 1930 as a result of the string of bank

closings already described. The Reserve System failed the test miserably. It did

little or nothing to provide the banking system with liquidity, apparently

regarding the bank closings as calling for no special action. It is worth

emphasizing, however, that the System's failure was a failure of will, not of

power. On this occasion, as on the later ones that followed, the System had

ample power to provide the banks with the cash their depositors were

demanding. Had this been done, the bank closings would have been cut short

and the monetary debacle averted.

The initial wave of bank failures died down and in early 1931 there were

signs of returning confidence. The Reserve System took advantage of the

opportunity to reduce its own credit outstanding which is to say, it offset the

naturally expansionary forces by engaging in mild deflationary action. Even so,

there were clear signs of improvement not only in the monetary sector but also

in other economic activities. The figures for the first four or five months of 1931,

if examined without reference to what actually followed, have all the earmarks of

the bottom of a cycle and the beginning of revival.

The tentative revival was however short-lived. Renewed bank failures

started another series of runs and again set in train a renewed decline in the

stock of money. Again, the Reserve System stood idly by. In the face of an

unprecedented liquidation of the commercial banking system, the books of the

"lender of last resort" show a decline in the amount of credit it made available to

its member banks.

In September 1931, Britain went off the gold standard. This act was

preceded and followed by gold withdrawals from the United States. Although

gold had been flowing into the United States in the prior two years, and the U.S.

gold stock and the Federal Reserve gold reserve ratio were at an all time high,

the Reserve System reacted vigorously and promptly to the external drain as it

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had not to the previous internal drain. It did so in a manner that was certain to

intensify the internal financial difficulties. After more than two years of severe

economic contraction, the System raised the discount rate the rate of interest at

which it stood ready to lend to member banks more sharply than it has within so

brief a period in its whole history before or since. The measure arrested the gold

drain. It was also accompanied by a spectacular increase in bank failures and

runs on banks. In the six months from August 1931 through January 1932,

roughly one out of ten banks in existence suspended operations and total

deposits in commercial banks fell by 15 per cent.

A temporary reversal of policy in 1932 involving the purchase of $ 1 billion

of government bonds slowed down the rate of decline. Had this measure been

taken in 1931, it would almost surely have been sufficient to prevent the debacle

just described. By 1932, it was too late to be more than a palliative and, when

the System relapsed into passivity, the temporary improvement was followed by

a renewed collapse terminating in the Banking Holiday of 1933 when every bank

in the United States was officially closed for over a week. A system established in

large part to prevent a temporary suspension of convertibility of deposits into

currency a measure that had formerly prevented banks from failing first let

nearly a third of the banks of the country go out of existence and then welcomed

a suspension of convertibility that was incomparably more sweeping and severe

than any earlier suspension. Yet so great is the capacity for self-justification that

the Federal Reserve Board could write in its annual report for 1933, "The ability

of the Federal Reserve Banks to meet enormous demands for currency during

the crisis demonstrated the effectiveness of the country's currency system under

the Federal Reserve Act. ... It is difficult to say what the course of the

depression would have been had the Federal Reserve System not pursued a

policy of liberal open market purchases."

All told, from July 1929 to March 1933, the money stock in the United

States fell by one-third, and over two-thirds of the decline came after England's

departure from the gold standard. Had the money stock been kept from

declining, as it clearly could and should have been, the contraction would have

been both shorter and far milder. It might still have been relatively severe by

historical standards. But it is literally inconceivable that money income could

have declined by over one-half and prices by over one-third in the course of four

years if there had been no decline in the stock of money. I know of no severe

depression in any country or any time that was not accompanied by a sharp

decline in the stock of money and equally of no sharp decline in the stock of

money that was not accompanied by a severe depression.

The Great Depression in the United States, far from being a sign of the

inherent instability of the private enterprise system, is a testament to how much

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harm can be done by mistakes on the part of a few men when they wield vast

power over the monetary system of a country.

It may be that these mistakes were excusable on the basis of the

knowledge available to men at the time though I happen to think not. But that is

really beside the point. Any system which gives so much power and so much

discretion to a few men that mistakes excusable or not can have such far-

reaching effects is a bad system. It is a bad system to believers in freedom just

because it gives a few men such power without any effective check by the body

politic this is the key political argument against an "independent" central bank.

But it is a bad system even to those who set security higher than freedom.

Mistakes, excusable or not, cannot be avoided in a system which disperses

responsibility yet gives a few men great power, and which thereby makes

important policy actions highly dependent on accidents of personality. This is the

key technical argument against an "independent" bank. To paraphrase

Clemenceau, money is much too serious a matter to be left to the Central

Bankers.

Rules Instead of Authorities

If we can achieve our objectives neither by relying on the working of a

thoroughly automatic gold standard nor by giving wide discretion to independent

authorities, how else can we establish a monetary system that is stable and at

the same time free from irresponsible governmental tinkering, a system that will

provide the necessary monetary framework for a free enterprise economy yet be

incapable of being used as a source of power to threaten economic and political

freedom?

The only way that has yet been suggested that offers promise is to try to

achieve a government of law instead of men by legislating rules for the conduct

of monetary policy that will have the effect of enabling the public to exercise

control over monetary policy through its political authorities, while at the same

time it will prevent monetary policy from being subject to the day-by-day whim

of political authorities.

The issue of legislating rules for monetary policy has much in common

with a topic that seems at first altogether different, namely, the argument for the

first amendment to the Constitution. Whenever anyone suggests the desirability

of a legislative rule for control over money, the stereotyped answer is that it

makes little sense to tie the monetary authority's hands in this way because the

authority, if it wants to, can always do of its own volition what the rule would

require it to do, and in addition has other alternatives, hence "surely," it is said,

it can do better than the rule. An alternative version of the same argument

applies it to the legislature. If the legislature is willing to adopt the rule, it is said,

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surely it will also be willing to legislate the "right" policy in each specific case.

How then, it is said, does the adoption of the rule provide any protection against

irresponsible political action?

The same argument could apply with only minor verbal changes to the

first amendment to the Constitution and, equally, to the entire Bill of Rights. Is it

not absurd, one might say, to have a standard proscription of interference with

free speech?

Why not take up each case separately and treat it on its own merits? Is

this not the counterpart to the usual argument in monetary policy that it is

undesirable to bind the hands of the monetary authority in advance; that it

should be left free to treat each case on its merits as it comes up? Why is not the

argument equally valid for speech? One man wants to stand up on a street

corner and advocate birth control; another, communism; a third, vegetarianism,

and so on, ad infinitum. Why not enact a law affirming or denying to each the

right to spread his particular views? Or, alternatively, why not give the power to

decide the issue to an administrative agency? It is immediately clear that if we

were to take each case up as it came, a majority would almost surely vote to

deny free speech in most cases and perhaps even in every case taken

separately. A vote on whether Mr. X should spread birth control propaganda

would almost surely yield a majority saying no; and so would one on

communism. The vegetarian might perhaps get by though even that is by no

means a foregone conclusion.

But now suppose all these cases were grouped together in one bundle,

and the populace at large were asked to vote for them as a whole; to vote

whether free speech should be denied in all cases or permitted in all alike. It is

perfectly conceivable, and I would say, highly probable, that an overwhelming

majority would vote for free speech; that, acting on the bundle as a whole, the

people would vote exactly the opposite to the way they would have voted on

each case separately. Why? One reason is that each person feels much more

strongly about being deprived of his right to free speech when he is in a minority

than he feels about depriving somebody else of the right to free speech when he

is in the majority. In consequence, when he votes on the bundle as a whole, he

gives much more weight to the infrequent denial of free speech to himself when

he is in the minority than to the frequent denial of free speech to others.

Another reason, and one that is more directly relevant to monetary policy,

is that if the bundle is viewed as a whole, it becomes clear that the policy

followed has cumulative effects that tend neither to be recognized nor taken into

account when each case is voted on separately. When a vote is taken on

whether Mr. Jones can speak on the corner, it cannot allow for the favorable

effects of an announced general policy of free speech. It cannot allow for the

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fact that a society in which people are not free to speak on the corner without

special legislation will be a society in which the development of new ideas,

experimentation, change, and the like will all be hampered in a great variety of

ways that are obvious to all, thanks to our good fortune of having lived in a

society which did adopt the self-denying ordinance of not considering each case

of speech separately.

Exactly the same considerations apply in the monetary area. If each case

is considered on its merits, the wrong decision is likely to be made in a large

fraction of cases because the decision-makers are examining only a limited area

and not taking into account the cumulative consequences of the policy as a

whole. On the other hand, if a general rule is adopted for a group of cases as a

bundle, the existence of that rule has favorable effects on people's attitudes and

beliefs and expectations that would not follow even from the discretionary

adoption of precisely the same policy on a s cries of separate occasions.

If a rule is to be legislated, what rule should it be? The rule that has most

frequently been suggested by people of a generally liberal persuasion is a price

level rule; namely, a legislative directive to the monetary authorities that they

maintain a stable price level. I think this is the wrong kind of a rule. It is the

wrong kind of a rule because it is in terms of objectives that the monetary

authorities do not have the clear and direct power to achieve by their own

actions. It consequently raises the problem of dispersing responsibilities and

leaving the authorities too much leeway. There is unquestionably a close

connection between monetary actions and the price level. But the connection is

not so close, so invariable, or so direct that the objective of achieving a stable

price level is an appropriate guide to the day-to-day activities of the authorities.

The issue what rule to adopt is one that I have considered at some length

elsewhere. 3 Accordingly, I will limit myself here to stating my conclusion. In the

present state of our knowledge, it seems to me desirable to state the rule in

terms of the behavior of the stock of money. My choice at the moment would be

a legislated rule instructing the monetary authority to achieve a specified rate of

growth in the stock of money. For this purpose, I would define the stock of

money as including currency outside commercial banks plus all deposits of

commercial banks. I would specify that the Reserve System shall see to it that

the total stock of money so defined rises month by month, and indeed, so far as

possible, day by day, at an annual rate of X per cent, where X is some number

between 3 and 5. The precise definition of money adopted, or the precise rate of

growth chosen, makes far less difference than the definite choice of a particular

definition and a particular rate of growth.

As matters now stand, while this rule would drastically curtail the

discretionary power of the monetary authorities, it would still leave an

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undesirable amount of discretion in the hands of Federal Reserve and Treasury

authorities with respect to how to achieve the specified rate of growth in the

money stock, debt management, banking supervision, and the like. Further

banking and fiscal reforms, which I have spelled out in detail elsewhere, are both

feasible and desirable. They would have the effect of eliminating present

governmental intervention into lending and investing activity and of converting

governmental financing operations from a perpetual source of instability and

uncertainty into a reasonably regular and predictable activity. But, though

important, these further reforms are far less basic than the adoption of a rule to

limit the discretion of the monetary authorities with respect to the stock of

money.

I should like to emphasize that I do not regard my particular proposal as a

be-all and end-all of monetary management, as a rule which is somehow to be

written in tablets of stone and enshrined for all future time. It seems to me to be

the rule that offers the greatest promise of achieving a reasonable degree of

monetary stability in the light of our present knowledge. I would hope that as we

operated with it, as we learned more about monetary matters, we might be able

to devise still better rules, which would achieve still better results. Such a rule

seems to me the only feasible device currently available for converting monetary

policy into a pillar of a free society rather than a threat to its foundations.

1 A Program for Monetary Stability (New York: Fordham University Press, 1959)

pp. 48.

2 See my A Program for Monetary Stability and Milton Friedman and Anna J.

Schwartz, A Monetary H istory of the United States, 18671960 (forthcoming by

Princeton University Press for the National Bureau of Economic Research).

3 A Program for Monetary Stability, op. cit., pp. 7799.

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Chapter I V

I nternational Financial and Trade Arrangements

The problem of international monetary arrangements is the relation

among different national currencies: the terms and conditions under which

individuals are able to convert U.S. dollars to pounds sterling, Canadian dollars to

U.S. dollars, and so on. This problem is closely connected with the control of

money discussed in the preceding chapter. It is connected also with

governmental policies about international trade, since control over international

trade is one technique for affecting international payments.

The Importance of International Monetary Arrangements for

Economic Freedom

Despite its technical character and forbidding complexity, the subject of

international monetary arrangements is one that a liberal cannot afford to

neglect. It is not too much to say that the most serious short-run threat to

economic freedom in the United States today aside, of course, from the outbreak

of World War III is that we shall be led to adopt far-reaching economic controls

in order to "solve" balance of payments problems. Interferences with

international trade appear innocuous; they can get the support of people who

are otherwise apprehensive of interference by government into economic affairs;

many a business man even regards them as part of the "American Way of Life";

yet there are few interferences which are capable of spreading so far and

ultimately being so destructive of free enterprise. There is much experience to

suggest that the most effective way to convert a market economy into an

authoritarian economic society is to start by imposing direct controls on foreign

exchange. This one step leads inevitably to the rationing of imports, to control

over domestic production that uses imported products or that produces

substitutes for imports, and so on in a never-ending spiral. Yet even so generally

staunch a champion of free enterprise as Senator Barry Goldwater has at times

been led, when discussing the so-called "gold flow," to suggest that restrictions

on transactions in foreign exchange may be necessary as a "cure." This "cure"

would be vastly worse than the disease.

There is seldom anything truly new under the sun in economic policy,

where the allegedly new generally turns out to be the discard of a prior century

in flimsy disguise. Unless I am mistaken, however, full-fledged exchange controls

and so-called "inconvertibility of currencies" are an exception and their origin

reveals their authoritarian promise. To the best of my knowledge they were

invented by Hjalmar Schacht in the early years of the Nazi regime. On many

occasions in the past, of course, currencies have been described as inconvertible.

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But what the word then meant was that the government of the day was

unwilling or unable to convert paper currency into gold or silver, or whatever the

monetary commodity was, at the legally stipulated rate. It seldom meant that a

country prohibited its citizens or residents from trading pieces of paper promising

to pay specified sums in the monetary unit of that country for corresponding

pieces of paper expressed in the monetary unit of another country or for that

matter for coin or bullion. During the Civil War in the United States and for a

decade and a half thereafter, for example, U.S. currency was inconvertible in the

sense that the holder of a greenback could not turn it in to the Treasury and get

a fixed amount of gold for it. But throughout the period he was free to buy gold

at the market price or to buy and sell British pounds for U.S. greenbacks at any

price mutually agreeable to the two parties.

In the United States, the dollar has been inconvertible in the older sense

ever since 1933. It has been illegal for American citizens to hold gold or to buy

and sell gold. The dollar has not been inconvertible in the newer sense. But

unfortunately we seem to be adopting policies that are highly likely, sooner or

later, to drive us in that direction.

The Role of Gold in the U.S. Monetary System

Only a cultural lag leads us still to think of gold as the central element in

our monetary system. A more accurate description of the role of gold in U.S.

policy is that it is primarily a commodity whose price is supported, like wheat or

other agricultural products. Our price-support program for gold differs in three

important respects from our price-support program for wheat: first, we pay the

support price to foreign as well as domestic producers; second, we sell freely at

the support price only to foreign purchasers and not to domestic; third, and this

is the one important relic of the monetary role of gold, the Treasury is authorized

to create money to pay for gold it buys to print paper money as it were so that

expenditures for the purchase of gold do not appear in the budget and the sums

required need not be explicitly appropriated by Congress; similarly, when the

Treasury sells gold, the books show simply a reduction in gold certificates, and

not a receipt that enters into the budget.

When the price of gold was first set at its present level of $ 35 an ounce

in 1934, this price was well above the free market price of gold. In consequence,

gold flooded the United States, our gold stock tripled in six years, and we came

to hold well over half the world's gold stock. We accumulated a "surplus" of gold

for the same reason we accumulated a "surplus" of wheat because the

government offered to pay a higher price than the market price. More recently,

the situation has changed. While the legally fixed price of gold has remained $

35, prices of other goods have doubled or tripled. Hence $ 35 is now less than

what the free market price would be. 1 As a result, we now face a "shortage"

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rather than a "surplus" for precisely the same reason that rent ceilings inevitably

produce a "shortage" of housing because the government is trying to hold the

price of gold below the market price.

The legal price of gold would long since have been raised as wheat prices

have been raised from time to time except for the accident that the major

producers of gold, and hence the major beneficiaries from a rise in its price, are

Soviet Russia and South Africa, the two countries with whom the United States

has least political sympathy.

Governmental control of the price of gold, no less than the control of any

other price, is inconsistent with a free economy. Such a pseudo gold standard

must be distinguished sharply from the use of gold as money under a real gold

standard which is entirely consistent with a free economy though it may not be

feasible. Even more than the price fixing itself, the associated measures taken in

1933 and 1934 by the Roosevelt administration when it raised the price of gold

represented a fundamental departure from liberal principles and established

precedents that have returned to plague the free world. I refer to the

nationalization of the gold stock, the prohibition of private possession of gold for

monetary purposes, and the abrogation of gold clauses in public and private

contracts.

In 1933 and early 1934, private holders of gold were required by law to

turn over their gold to the federal government. They were compensated at a

price equal to the prior legal price, which was at the time decidedly below the

market price. To make this requirement effective, private ownership of gold

within the U.S. was made illegal except for use in the arts. One can hardly

imagine a measure more destructive of the principles of private property on

which a free enterprise society rests. There is no difference in principle between

this nationalization of gold at an artificially low price and Fidel Castro's

nationalization of land and factories at an artificially low price. On what grounds

of principle can the U.S. object to the one after having itself engaged in the

other? Yet so great is the blindness of some supporters of free enterprise with

respect to anything touching gold that in 1960 Henry Alexander, head of the

Morgan Guaranty Trust Company, successor to J . P. Morgan and Company,

proposed that the prohibition against the private ownership of gold by U.S.

citizens be extended to cover gold held abroad! And his proposal was adopted by

President Eisenhower with hardly a protest from the banking community.

Though rationalized in terms of "conserving" gold for monetary use,

prohibition of private ownership of gold was not enacted for any such monetary

purpose, whether itself good or bad. The nationalization of gold was enacted to

enable the government to reap the whole of the "paper" profit from the rise in

the price of gold or perhaps, to prevent private individuals from benefiting.

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The abrogation of the gold clauses had a similar purpose. And this too

was a measure destructive of the basic principles of free enterprise. Contracts

entered into in good faith and with full knowledge on the part of both parties to

them were declared invalid for the benefit of one of the parties!

Current Payments and Capital Flight

In discussing international monetary relations on a more general level, it

is necessary to distinguish two rather different problems: the balance of

payments, and the danger of a run on gold. The difference between the

problems can be illustrated most simply by considering the analogy of an

ordinary commercial bank. The bank must so arrange its affairs that it takes in as

service charges, interest on loans, and so on a large enough sum to enable it to

pay its expenses wages and salaries, interest on borrowed funds, cost of

supplies, returns to stockholders, and so on. It must strive, that is, for a healthy

income account. But a bank which is in good shape on its income account may

nonetheless experience serious trouble if for any reason its depositors should

lose confidence in it and suddenly demand their deposits en masse. Many a

sound bank was forced to close its doors because of such a run on it during the

liquidity crises described in the preceding chapter.

These two problems are not of course unrelated. One important reason

why a bank's depositors may lose confidence in it is because the bank is

experiencing losses on income account. Yet the two problems are also very

different. For one thing, problems on income account are generally slow to arise

and considerable time is available to solve them. They seldom come as sudden

surprises. A run, on the other hand, may arise suddenly and unpredictably out of

thin air.

The situation of the U.S. is precisely parallel. Residents of the United

States and the U.S. government itself are seeking to buy foreign currencies with

dollars in order to purchase goods and services in other countries, to invest in

foreign enterprises, to pay interest on debts, to repay loans, or to give gifts to

others, whether private or public. At the same time, foreigners are seeking to

acquire dollars with foreign currencies for corresponding purposes. After the

event, the number of dollars spent for foreign currency will precisely equal the

number of dollars purchased with foreign currency just as the number of pairs of

shoes sold is precisely equal to the number bought. Arithmetic is arithmetic and

one man's purchase is another man's sale. But there is nothing to assure that, at

any given price of foreign currency in terms of dollars, the number of dollars that

some want to spend will equal the number others want to buy just as there is

nothing to assure that at any given price of shoes the number of pairs of shoes

people want to buy is exactly equal to the number of pairs other people want to

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sell. The ex post equality reflects some mechanism that eliminates any ex ante

discrepancy. The problem of achieving an appropriate mechanism for this

purpose is the counterpart of the bank's problem on income account.

In addition, the United States has a problem like the bank's of avoiding a

run. The U.S. is committed to sell gold to foreign central banks and governments

at $ 35 an ounce. Foreign central banks, governments, and residents hold large

funds in the United States in the form of deposit accounts or U.S. securities that

can be readily sold for dollars. At any time, the holders of these balances can

start a run on the U.S. Treasury by trying to convert their dollar balances into

gold. This is precisely what happened in the fall of 1960, and what is very likely

to happen again at some unpredictable date in the future (perhaps before this is

printed).

The two problems are related in two ways. In the first place, as for a

bank, income account difficulties are a major source of loss of confidence in the

ability of the U.S. to honor its promise to sell gold at $ 35 an ounce. The fact

that the U.S. has in effect been having to borrow abroad in order to achieve

balance on current account is a major reason why holders of dollars are

interested in converting them into gold or other currencies. In the second place,

the fixed price of gold is the device we have adopted for pegging another set of

prices the price of the dollar in terms of foreign currencies and flows of gold are

the device we have adopted for resolving ex ante discrepancies in the balance of

payments.

Alternative Mechanisms for Achieving Balance in Foreign Payments

We can get more light on both of these relations by considering what

alternative mechanisms are available for achieving balance in payments the first

and in many ways the more fundamental of the two problems.

Suppose that the U.S. is roughly in balance in its international payments

and that something comes along which alters the situation by, let us say,

reducing the number of dollars that foreigners want to buy compared to the

number that U.S. residents want to sell; or, looking at it from the other side,

increasing the amount of foreign currency that holders of dollars want to buy

compared to the amount that holders of foreign currency want to sell for dollars.

That is, something threatens to produce a "deficit" in U.S. payments. This might

result from increased efficiency in production abroad or decreased efficiency at

home, increased foreign aid expenditures by the U.S. or reduced ones by other

countries, or a million and one other changes of the kind that are always

occurring.

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There are four, and only four ways, in which a country can adjust to such

a disturbance and some combination of these ways must be used.

1. U.S. reserves of foreign currencies can be drawn down or foreign

reserves of U.S. currency built up. In practice, this means that the U.S.

government can let its stock of gold go down, since gold is exchangeable for

foreign currencies, or it can borrow foreign currencies and make them available

for dollars at official exchange rates; or foreign governments can accumulate

dollars by selling U.S. residents foreign currencies at official rates. Reliance on

reserves is obviously at best a temporary expedient. Indeed, it is precisely the

extensive use by the U.S. of this expedient that accounts for the great concern

with the balance of payments.

2. Domestic prices within the U.S. can be forced down relative to foreign

prices. This is the main adjustment mechanism under a full-fledged gold

standard. An initial deficit would produce an outflow of gold (mechanism 1,

above); the outflow of gold would produce a decline in the stock of money; the

decline in the stock of money would produce a fall in prices and incomes at

home. At the same time, the reverse effects would occur abroad: the inflow of

gold would expand the stock of money and thereby raise prices and income.

Lowered U.S. prices and increased foreign prices would make U.S. goods more

attractive to foreigners and thereby raise the number of dollars they wanted to

buy; at the same time, the price changes would make foreign goods less

attractive to U.S. residents and thereby lower the number of dollars they wanted

to sell. Both effects would operate to reduce the deficit and restore balance

without the necessity for further gold flows.

Under the modern managed standard, these effects are not automatic.

Gold flows may still occur as the first step, but they will not affect the stock of

money in either the country that loses, or the country that gains gold, unless the

monetary authorities in the separate countries decide that they should. In every

country today, the central bank or the Treasury has the power to offset the

influence of gold flows, or to change the stock of money without gold flows.

Hence this mechanism will be used only if the authorities in the country

experiencing the deficit are willing to produce a deflation, thereby creating

unemployment, in order to resolve its payments problem, or the authorities in

the country experiencing the surplus are willing to produce an inflation.

3. Exactly the same effects can be achieved by a change in exchange

rates as by a change in domestic prices. For example, suppose that under

mechanism 2 the price of a particular car in the United States fell by 10 per cent

from $ 2,800 to $ 2,520. If the price of the pound is throughout $ 2.80, this

means that the price in Britain (neglecting freight and other charges) would fall

from £1, 000 to £900. Exactly the same decline in the British price will occur

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without any change in the United States price if the price of a pound rises from $

2.80 to $ 3.11. Formerly, the Englishman had to spend £1,000 to get $ 2,800.

Now he can get $ 2,800 for only £900. He would not know the difference

between this reduction in cost and the corresponding reduction through a fall in

the U.S. price without a change in exchange rate.

In practice, there are several ways in which the change in exchange rates

can occur. With the kinds of pegged exchange rates many countries now have, it

can occur through devaluation or appreciation, which is to say, a governmental

declaration that it is changing the price at which it proposes to peg its currency.

Alternatively, the exchange rate docs not need to be pegged at all. It can be a

market rate changing from day to day, as was the case with the Canadian dollar

from 1950 to 1962. If a market rate, it can be a truly free market rate

determined primarily by private transactions as the Canadian rate apparently was

from 1952 to 1961, or it can be manipulated by government speculation as was

the situation in Britain from 1931 to 1939, and in Canada from 1950 to 1952 and

again from 1961 to 1962.

Of these various techniques, only the freely floating exchange rate is fully

automatic and free from governmental control.

4. The adjustments produced by mechanisms 2 and 3 consist of changes

in flows of commodities and services induced by changes either in internal prices

or exchange rates. Instead, direct governmental controls or interferences with

trade could be used to reduce attempted U.S. expenditures of dollars and

expand U.S. receipts. Tariffs could be raised to choke off imports, subsidies could

be given to stimulate exports, import quotas could be imposed on a variety of

goods, capital investment abroad by U.S. citizens or firms could be controlled,

and so on and on up to the whole paraphernalia of exchange controls. In this

category must be included not only controls over private activities but also

changes in governmental programs for balance of payments purposes. Recipients

of foreign aid may be required to spend the aid in the U.S.; the military may

procure goods in the United States at greater expense instead of abroad in order

to save "dollars" in the self-contradictory terminology used and so on in

bewildering array.

The important thing to note is that one or another of these four ways will

and must be used. Double entry books must balance. Payments must equal

receipts. The only question is how.

Our announced national policy has been and continues to be that we shall

do none of these things. In a speech in December 1961, to the National

Association of Manufacturers, President Kennedy stated "This administration,

therefore, during its term of office and I repeat this and make it as a flat

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statement has no intention of imposing exchange controls, devaluing the dollar,

raising trade barriers or choking off our economic recovery." As a matter of logic,

this leaves only two possibilities: getting other countries to take the relevant

measures, which is hardly a recourse that we can be sure of, or drawing down

reserves, which the President and other officials repeatedly stated must not be

permitted to continue. Yet Time magazine reports that the President's "promise

drew a burst of applause" from the assembled businessmen. So far as our

announced policy is concerned, we are in the position of a man living beyond his

income who insists that he cannot possibly earn more, or spend less, or borrow,

or finance the excess out of his assets!

Because we have been unwilling to adopt any one coherent policy, we and

our trading partners who make the same ostrich-like pronouncements as we do

have perforce been led to resort to all four mechanisms. In the early postwar

years, U.S. reserves rose; more recently they have been declining. We welcomed

inflation more readily than we otherwise would have when reserves were rising,

and we have been more deflationary since 1958 than we would otherwise have

been because of the drain of gold. Though we have not changed our official

price of gold, our trading partners have changed theirs, and thereby the

exchange rate between their currency and the dollar, and U.S. pressure has not

been absent in producing these adjustments. Finally, our trading partners used

direct controls extensively and, since we instead of they have been faced with

deficits, we too have resorted to a wide range of direct interferences with

payments, from reducing the amount of foreign goods that tourists can bring in

free of duty a trivial yet highly symptomatic step to requiring foreign aid

expenditures to be spent in the U.S., to keeping families from joining servicemen

overseas, to more stringent import quotas on oil. We have been led also to

engage in the demeaning step of asking foreign governments to take special

measures to strengthen the U.S. balance of payments.

Of the four mechanisms, the use of direct controls is clearly the worst

from almost any point of view and certainly the most destructive of a free

society. Yet in lieu of any clear policy, we have been led increasingly to rely on

such controls in one form or another. We preach publicly the virtues of free

trade; yet we have been forced by the inexorable pressure of the balance of

payments to move in the opposite direction and there is great danger that we

shall move still farther. We can pass all the laws imaginable to reduce tariffs; the

Administration may negotiate any number of tariff reductions; yet unless we

adopt an alternative mechanism for resolving balance of payments deficits, we

shall be led to substitute one set of trade impediments for another indeed, to

substitute a worse set for a better. While tariffs are bad, quotas and other direct

interferences are even worse. A tariff, like a market price, is impersonal and does

not involve direct interference by government in business affairs; a quota is likely

to involve allocation and other administrative interferences, besides giving

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administrators valuable plums to pass out to private interests. Perhaps worse

than either tariffs or quotas are extra-legal arrangements, such as the

"voluntary" agreement by Japan to restrict textile exports.

Floating Exchange Rates as the Free Market Solution

There are only two mechanisms that are consistent with a free market

and free trade. One is a fully automatic international gold standard. This, as we

saw in the preceding chapter, is neither feasible nor desirable. In any event, we

cannot adopt it by ourselves. The other is a system of freely floating exchange

rates determined in the market by private transactions without governmental

intervention. This is the proper free market counterpart to the monetary rule

advocated in the preceding chapter. If we do not adopt it, we shall inevitably fail

to expand the area of free trade and shall sooner or later be induced to impose

widespread direct controls over trade. In this area, as in others, conditions can

and do change unexpectedly. It may well be that we shall muddle through the

difficulties that are facing us as this is written (April, 1962) and indeed that we

may find ourselves in a surplus rather than deficit position, accumulating

reserves rather than losing them. If so, this will only mean that other countries

will be faced with the necessity of imposing controls. When, in 1950, I wrote an

article proposing a system of floating exchange rates, it was in the context of

European payments difficulties accompanying the then alleged "dollar shortage."

Such a turnabout is always possible. Indeed, it is the very difficulty of predicting

when and how such changes occur that is the basic argument for a free market.

Our problem is not to "solve" a balance of payments problem. It is to solve the

balance of payments problem by adopting a mechanism that will enable free

market forces to provide a prompt, effective, and automatic response to changes

in conditions affecting international trade.

Though freely floating exchange rates seem so clearly to be the

appropriate free-market mechanism, they are strongly supported only by a fairly

small number of liberals, mostly professional economists, and are opposed by

many liberals who reject governmental intervention and governmental price

fixing in almost every other area. Why is this so? One reason is simply the

tyranny of the status quo. A second reason is the confusion between a real gold

standard and a pseudo gold standard. Under a real gold standard, the prices of

different national currencies in terms of one another would be very nearly rigid

since the different currencies would simply be different names for different

amounts of gold. It is easy to make the mistake of supposing that we can get

the substance of the real gold standard by the mere adoption of the form of a

nominal obeisance to gold the adoption of a pseudo gold standard under which

the prices of different national currencies in terms of one another are rigid only

because they are pegged prices in rigged markets. A third reason is the

inevitable tendency for everyone to be in favor of a free market for everyone

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else, while regarding himself as deserving of special treatment. This particularly

affects bankers in respect of exchange rates. They like to have a guaranteed

price. Moreover, they are not familiar with the market devices that would arise to

cope with fluctuations in exchange rates. The firms that would specialize in

speculation and arbitrage in a free market for exchange do not exist. This is one

way the tyranny of the status quo is enforced. In Canada, for example, some

bankers, after a decade of a free rate which gave them a different status quo,

were in the forefront of those favoring its continuation and objecting to either a

pegged rate or government manipulation of the rate.

More important than any of these reasons, I believe, is a mistaken

interpretation of experience with floating rates, arising out of a statistical fallacy

that can be seen easily in a standard example. Arizona is clearly the worst place

in the U.S. for a person with tuberculosis to go because the death rate from

tuberculosis is higher in Arizona than in any other state. The fallacy is in this

case obvious. It is less obvious in connection with exchange rates. When

countries have gotten into severe financial difficulties through internal monetary

mismanagement or for any other reason, they have had ultimately to resort to

flexible exchange rates. No amount of exchange control or direct restrictions on

trade enabled them to peg an exchange rate that was far out of line with

economic realities. In consequence, it is unquestionably true that floating

exchange rates have frequently been associated with financial and economic

instability as, for example, in hyperinflations, or severe but not hyperinflations

such as have occurred in many South American countries. It is easy to conclude,

as many have, that floating exchange rates produce such instability.

Being in favor of floating exchange rates does not mean being in favor of

unstable exchange rates. When we support a free price system at home, this

does not imply that we favor a system in which prices fluctuate wildly up and

down. What we want is a system in which prices are free to fluctuate but in

which the forces determining them are sufficiently stable so that in fact prices

move within moderate ranges. This is equally true of a system of floating

exchange rates. The ultimate objective is a world in which exchange rates, while

free to vary, are, in fact, highly stable because basic economic policies and

conditions are stable. Instability of exchange rates is a symptom of instability in

the underlying economic structure. Elimination of this symptom by administrative

freezing of exchange rates cures none of the underlying difficulties and only

makes adjustments to them more painful.

The Policy Measures Necessary for a Free Market in Gold and Foreign

Exchange

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It may help bring out in concrete terms the implications of this discussion

if I specify in detail the measures that I believe the U.S. should take to promote

a truly free market in both gold and foreign exchange.

1. The U.S. should announce that it no longer commits itself to buy or sell

gold at any fixed price.

2. Present laws making it illegal for individuals to own gold or to buy and

sell gold should be repealed, so that there are no restrictions on the price at

which gold can be bought or sold in terms of any other commodity or financial

instrument, including national currencies.

3. The present law specifying that the Reserve System must hold gold

certificates equal to 25 per cent of its liabilities should be repealed.

4. A major problem in getting rid completely of the gold price-support

program, as of the wheat price-support program, is the transitional one of what

to do with accumulated government stocks. In both cases, my own view is that

the government should immediately restore a free market by instituting steps 1

and 2, and should ultimately dispose of all of its stocks. However, it would

probably be desirable for the government to dispose of its stocks only gradually.

For wheat, five years has always seemed to me a long enough period, so I have

favored the government committing itself to dispose of one-fifth of its stocks in

each of five years. This period seems reasonably satisfactory for gold as well.

Hence, I propose that the government auction off its gold stocks on the free

market over a five-year period. With a free gold market, individuals may well find

warehouse certificates for gold more useful than actual gold. But if so, private

enterprise can certainly provide the service of storing the gold and issuing

certificates. Why should gold storage and the issuance of warehouse certificates

be a nationalized industry?

5. The U.S. should announce also that it will not proclaim any official

exchange rates between the dollar and other currencies and in addition that it

will not engage in any speculative or other activities aimed at influencing

exchange rates. These would then be determined in free markets.

6. These measures would conflict with our formal obligation as a member

of the International Monetary Fund to specify an official parity for the dollar.

However, the Fund found it possible to reconcile Canada's failure to specify a

parity with its Articles and to give its approval to a floating rate for Canada.

There is no reason why it cannot do the same for the U.S.

7. Other nations might choose to peg their currencies to the dollar. That is

their business and there is no reason for us to object so long as we undertake no

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obligations to buy or sell their currency at a fixed price. They will be able to

succeed in pegging their currency to ours only by one or more of the measures

listed earlier drawing on or accumulating reserves, coordinating their internal

policy with U.S. policy, tightening or loosening direct controls on trade.

Eliminating U.S. Restrictions on Trade

A system such as that just outlined would solve the balance of payments

problem once and for all. No deficit could possibly arise to require high

government officials to plead with foreign countries and central banks for

assistance, or to require an American President to behave like a harried country

banker trying to restore confidence in his bank, or to force an administration

preaching free trade to impose import restrictions, or to sacrifice important

national and personal interests to the trivial question of the name of the currency

in which payments are made. Payments would always balance because a price

the foreign exchange rate would be free to produce a balance. No one could sell

dollars unless he could find someone to buy them and conversely.

A system of floating exchange rates would therefore enable us to proceed

effectively and directly toward complete free trade in goods and services barring

only such deliberate interference as may be justified on strictly political and

military grounds; for example, banning the sale of strategic goods to communist

countries. So long as we are firmly committed to the strait jacket of fixed

exchange rates, we cannot move definitively to free trade. The possibility of

tariffs or direct controls must be retained as an escape valve in case of necessity.

A system of floating exchange rates has the side advantage that it makes

almost transparently obvious the fallacy in the most popular argument against

free trade, the argument that "low" wages elsewhere make tariffs somehow

necessary to protect "high" wages here. Is 100 yen an hour to a Japanese

worker high or low compared with $ 4 an hour to an American worker? That all

depends on the exchange rate. What determines the exchange rate? The

necessity of making payments balance; i.e., of making the amount we can sell to

the J apanese roughly equal to the amount they can sell to us.

Suppose for simplicity that Japan and the U.S. are the only two countries

involved in trade and that at some exchange rate, say 1,000 yen to the dollar,

Japanese could produce every single item capable of entering into foreign trade

more cheaply than the U.S. At that exchange rate the Japanese could sell much

to us, we, nothing to them. Suppose we pay them in paper dollars. What would

the Japanese exporters do with the dollars? They cannot eat them, wear them,

or live in them. If they were willing simply to hold them, then the printing

industry printing the dollar bills would be a magnificent export industry. Its

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output would enable us all to have the good things of life provided nearly free by

the J apanese.

But, of course, Japanese exporters would not want to hold the dollars.

They would want to sell them for yen. By assumption, there is nothing they can

buy for a dollar that they cannot buy for less than the 1,000 yen that a dollar will

by assumption exchange for. This is equally true for other Japanese. Why then

would any holder of yen give up 1,000 yen for a dollar that will buy less in goods

than the 1,000 yen will? No one would. In order for the Japanese exporter to

exchange his dollars for yen, he would have to offer to take fewer yen the price

of the dollar in terms of the yen would have to be less than 1, 000, or of the yen

in terms of the dollar more than I mill. But at 500 yen to the dollar Japanese

goods are twice as expensive to Americans as before; American goods half as

expensive to the Japanese. The Japanese will no longer be able to undersell

American producers on all items.

Where will the price of the yen in terms of dollars settle? At whatever

level is necessary to assure that all exporters who desire to do so can sell the

dollars they get for the goods they export to America to importers who use them

to buy goods in America. To speak loosely, at whatever level is necessary to

assure that the value of U.S. exports (in dollars) is equal to the value of U.S.

imports (again in dollars). Loosely, because a precise statement would have to

take into account capital transactions, gifts, and so on. But these do not alter the

central principle.

It will be noted that this discussion says nothing about the level of living

of the Japanese worker or the American worker. These are irrelevant. If the

Japanese worker has a lower standard of living than the American, it is because

he is less productive on the average than the American, given the training he

has, the amount of capital and land and so on that he has to work with. If the

American worker is, let us say, on the average four times as productive as the

Japanese worker, it is wasteful to use him to produce any goods in the

production of which he is less than four times as productive. It is better to

produce those goods at which he is more productive and trade them for the

goods at which he is less productive. Tariffs do not assist the J apanese worker to

raise his standard of living or protect the high standard of the American worker.

On the contrary, they lower the Japanese standard and keep the American

standard from being as high as it could be.

Given that we should move to free trade, how should we do so? The

method that we have tried to adopt is reciprocal negotiation of tariff reductions

with other countries. This seems to me a wrong procedure. In the first place, it

ensures a slow pace. He moves fastest who moves alone. In the second place, it

fosters an erroneous view of the basic problem. It makes it appear as if tariffs

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help the country imposing them but hurt other countries, as if when we reduce a

tariff we give up something good and should get something in return in the form

of a reduction in the tariffs imposed by other countries. In truth, the situation is

quite different. Our tariffs hurt us as well as other countries. We would be

benefited by dispensing with our tariffs even if other countries did not. 2 We

would of course be benefited even more if they reduced theirs but our benefiting

does not require that they reduce theirs. Self interests coincide and do not

conflict.

I believe that it would be far better for us to move to free trade

unilaterally, as Britain did in the nineteenth century when it repealed the corn

laws. We, as they did, would experience an enormous accession of political and

economic power. We are a great nation and it ill behooves us to require

reciprocal benefits from Luxembourg before we reduce a tariff on Luxembourg

products, or to throw thousands of Chinese refugees suddenly out of work by

imposing import quotas on textiles from Hong Kong. Let us live up to our destiny

and set the pace not be reluctant followers.

I have spoken in terms of tariffs for simplicity but, as already noted, non-

tariff restrictions may now be more serious impediments to trade than tariffs. We

should remove both. A prompt yet gradual program would be to legislate that all

import quotas or other quantitative restrictions, whether imposed by us or

"voluntarily" accepted by other countries, be raised 20 per cent a year until they

are so high that they become irrelevant and can be abandoned, and that all

tariffs be reduced by one-tenth of the present level in each of the next ten years.

There are few measures we could take that would do more to promote

the cause of freedom at home and abroad. Instead of making grants to foreign

governments in the name of economic aid and thereby promoting socialism while

at the same time imposing restrictions on the products they succeed in

producing and thereby hindering free enterprise we could assume a consistent

and principled stance. We could say to the rest of the world: We believe in

freedom and intend to practice it. No one can force you to be free. That is your

business. But we can offer you full co-operation on equal terms to all. Our

market is open to you. Sell here what you can and wish to. Use the proceeds to

buy what you wish. In this way co-operation among individuals can be world

wide yet free.

1 A warning is in order that this is a subtle point that depends on what is held

constant in estimating the free market price, particularly with respect to gold's

monetary role.

2 There are conceivable exceptions to these statements but, so far as I can see,

they are theoretical curiosities, not relevant practical possibilities.

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Chapter V

Fiscal Policy

Ever since the new deal, a primary excuse for the expansion of

governmental activity at the federal level has been the supposed necessity for

government spending to eliminate unemployment. The excuse has gone through

several stages. At first, government spending was needed to "prime the pump."

Temporary expenditures would set the economy going and the government

could then step out of the picture.

When the initial expenditures failed to eliminate unemployment and were

followed by a sharp economic contraction in 193738, the theory of "secular

stagnation" developed to justify a permanently high level of government

spending. The economy had become mature, it was argued. Opportunities for

investment had been largely exploited and no substantial new opportunities were

likely to arise. Yet individuals would still want to save. Hence, it was essential for

government to spend and run a perpetual deficit. The securities issued to finance

the deficit would provide individuals with a way to accumulate savings while the

government expenditures provided employment. This view has been thoroughly

discredited by theoretical analysis and even more by actual experience, including

the emergence of wholly new lines for private investment not dreamed of by the

secular stagnationists. Yet it has left its heritage. The idea may be accepted by

none, but the government programs undertaken in its name, like some of those

intended to prime the pump, are still with us and indeed account for ever-

growing government expenditures.

More recently, the emphasis has been on government expenditures

neither to prime the pump nor to hold in check the specter of secular stagnation

but as a balance wheel. When private expenditures decline for any reason, it is

said, governmental expenditures should rise to keep total expenditures stable;

conversely, when private expenditures rise, governmental expenditures should

decline. Unfortunately, the balance wheel is unbalanced. Each recession,

however minor, sends a shudder through politically sensitive legislators and

administrators with their ever present fear that perhaps it is the harbinger of

another 192933. They hasten to enact federal spending programs of one kind or

another. Many of the programs do not in fact come into effect until after the

recession has passed. Hence, insofar as they do affect total expenditures, on

which I shall have more to say later, they tend to exacerbate the succeeding

expansion rather than to mitigate the recession. The haste with which spending

programs are approved is not matched by an equal haste to repeal them or to

eliminate others when the recession is passed and expansion is under way. On

the contrary, it is then argued that a "healthy" expansion must not be

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"jeopardized" by cuts in governmental expenditures. The chief harm done by the

balance-wheel theory is therefore not that it has failed to offset recessions,

which it has, and not that it has introduced an inflationary bias into

governmental policy, which it has done too, but that it has continuously fostered

an expansion in the range of governmental activities at the federal level and

prevented a reduction in the burden of federal taxes.

In view of the emphasis on using the federal budget as a balance wheel, it

is ironic that the most unstable component of national income in the postwar

period is federal expenditure, and the instability has not at all been in a direction

to offset movements of other expenditure components. Far from being a balance

wheel offsetting other forces making for fluctuations, the federal budget has if

anything been itself a major source of disturbance and instability.

Because its expenditures are now so large a part of the total for the

economy as a whole, the federal government cannot avoid having significant

effects on the economy. The first requisite is therefore that the government

mend its own fences, that it adopt procedures that will lead to reasonable

stability in its own flow of expenditures. If it would do that, it would make a clear

contribution to reducing the adjustments required in the rest of the economy.

Until it does that, it is farcical for government officials to adopt the self-righteous

tones of the schoolmaster keeping unruly pupils in line. Of course, their doing so

is not surprising. Passing the buck and blaming others for one's own deficiencies

are not vices of which governmental officials have a monopoly.

Even if one were to accept the view that the federal budget should be and

can be used as a balance wheel a view I shall consider in more detail below

there is no necessity to use the expenditure side of the budget for this purpose.

The tax side is equally available. A decline in national income automatically

reduces the tax revenue of the federal government in greater proportion and

thus shifts the budget in the direction of a deficit, and conversely during a boom.

If it is desired to do more, taxes can be lowered during recessions and raised

during expansions. Of course, politics might well enforce an asymmetry here too,

making the declines politically more palatable than the rises.

If the balance-wheel theory has in practice been applied on the

expenditure side, it has been because of the existence of other forces making for

increased governmental expenditures; in particular, the widespread acceptance

by intellectuals of the belief that government should play a larger role in

economic and private affairs; the triumph, that is, of the philosophy of the

welfare state. This philosophy has found a useful ally in the balance-wheel

theory; it has enabled governmental intervention to proceed at a faster pace

than would otherwise have been possible.

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How different matters might now be if the balance-wheel theory had been

applied on the tax side instead of the expenditure side. Suppose each recession

had seen a cut in taxes and suppose the political unpopularity of raising taxes in

the succeeding expansion had led to resistance to newly proposed governmental

expenditure programs and to curtailment of existing ones. We might now be in a

position where federal expenditures would be absorbing a good deal less of a

national income that would be larger because of the reduction in the depressing

and inhibiting effects of taxes.

I hasten to add that this dream is not intended to indicate support for the

balance-wheel theory. In practice, even if the effects would be in the direction

expected under the balance wheel theory, they would be delayed in time and

spread. To make them an effective offset to other forces making for fluctuations,

we would have to be able to forecast those fluctuations a long time in advance.

In fiscal policy as in monetary policy, all political considerations aside, we simply

do not know enough to be able to use deliberate changes in taxation or

expenditures as a sensitive stabilizing mechanism. In the process of trying to do

so, we almost surely make matters worse. We make matters worse not by being

consistently perverse that would be easily cured by simply doing the opposite of

what seemed at first the thing to do. We make matters worse by introducing a

largely random disturbance that is simply added to other disturbances. That is

what we seem in fact to have done in the past in addition, of course to the major

mistakes that have been seriously perverse. What I have written elsewhere in

respect of monetary policy is equally applicable to fiscal policy: "What we need is

not a skillful monetary driver of the economic vehicle continuously turning the

steering wheel to adjust to the unexpected irregularities of the route, but some

means of keeping the monetary passenger who is in the back seat as ballast

from occasionally leaning over and giving the steering wheel a jerk that

threatens to send the car off the road ." 1

For fiscal policy, the appropriate counterpart to the monetary rule would

be to plan expenditure programs entirely in terms of what the community wants

to do through government rather than privately, and without any regard to

problems of year-to-year economic stability; to plan tax rates so as to provide

sufficient revenues to cover planned expenditures on the average of one year

with another, again without regard to year-to-year changes in economic stability;

and to avoid erratic changes in either governmental expenditures or taxes. Of

course, some changes may be unavoidable. A sudden change in the international

situation may dictate large increases in military expenditures or permit welcome

decreases. Such changes account for some erratic shifts in federal expenditures

in the postwar period. But they by no means account for all.

Before leaving the subject of fiscal policy, I should like to discuss the view,

now so widely held, that an increase in governmental expenditures relative to

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tax-receipts is necessarily expansionary and a decrease contractionary. This

view, which is at the heart of the belief that fiscal policy can serve as a balance

wheel, is by now almost taken for granted by businessmen, professional

economists, and laymen alike. Yet it cannot be demonstrated to be true by

logical considerations alone, has never been documented by empirical evidence,

and is in fact inconsistent with the relevant empirical evidence of which I know.

The belief has its origin in a crude Keynesian analysis. Suppose

governmental expenditures are raised by $ 100 and taxes are kept unchanged.

Then, goes the simple analysis, on the first round, the people who receive the

extra hundred dollars will have that much more income. They will save some of

it, say one-third, and spend the remaining two-thirds. But this means that on the

second round, someone else receives an extra $ 66 2/3 of income. He in turn will

save some and spend some, and so on and on in infinite sequence. If at every

stage one-third is saved and two-thirds spent, then the extra $ 100 of

government expenditures will ultimately, on this analysis, add $ 300 to income.

This is the simple Keynesian multiplier analysis with a multiplier of three. Of

course, if there is one injection, the effects will die off, the initial jump in income

of $ 100 being succeeded by a gradual decline back to the earlier level. But if

government expenditures are kept $ 100 higher per unit of time, say $ 100 a

year higher, then, on this analysis, income will remain higher by $ 300 a year.

This simple analysis is extremely appealing. But the appeal is spurious and

arises from neglecting other relevant effects of the change in question. When

these are taken into account, the final result is much more dubious: it may be

anything from no change in income at all, in which case private expenditures will

go down by the $ 100 by which government expenditures go up, to the full

increase specified. And even if money income increases, prices may rise, so real

income will increase less or not at all. Let us examine some of the possible slips'

twixt cup and lip.

In the first place, nothing is said in the simple account about what the

government spends the $ 100 on. Suppose, for example, it spends it on

something that individuals were otherwise obtaining for themselves. They were,

for example, spending $ 100 on paying fees to a park which paid the cost of

attendants to keep it clean. Suppose the government now pays these costs and

permits people to enter the park "free." The attendants still receive the same

income, but the people who paid the fees have $ 100 available. The government

spending does not, even in the initial stage, add $ 100 to anyone's income. What

it does is to leave some people with $ 100 available to use for purposes other

than the park, and presumably purposes they value less highly. They can be

expected to spend less out of their total income for consumer goods than

formerly, since they are receiving the park services free. How much less, it is not

easy to say. Even if we accept, as in the simple analysis, that people save one-

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third of additional income, it does not follow that when they get one set of

consumer goods "free," two-thirds of the released money will be spent on other

consumer goods. One extreme possibility, of course, is that they will continue to

buy the same collection of other consumer goods as they did before and add the

released $100 to their savings. In this case even in the simple Keynesian

analysis, the effect of the government expenditures is completely offset:

government expenditures go up by $100, private down by $100. Or, to take

another example, the $100 may be spent to build a road that a private enterprise

would otherwise have built or the availability of which may make repairs to the

company's trucks unnecessary. The firm then has funds released, but

presumably will not spend them all on what are less attractive investments. In

these cases, government expenditures simply divert private expenditures and

only the net excess of government expenditures is even available at the outset

for the multiplier to work on. From this point of view, it is paradoxical that the

way to assure no diversion is to have the government spend the money for

something utterly useless this is the limited intellectual content to the "filling-

holes" type of make-work. But of course this itself shows that there is something

wrong with the analysis.

In the second place, nothing is said in the simple account about where the

government gets the $ 100 to spend. So far as the analysis goes, the results are

the same whether the government prints extra money or borrows from the

public. But surely which it does will make a difference. To separate fiscal from

monetary policy, let us suppose the government borrows the $ 100 so that the

stock of money is the same as it would have been in the absence of the

government expenditure. This is the proper assumption because the stock of

money can be increased without extra government expenditure, if that is

desired, simply by printing the money and buying outstanding government bonds

with it. But we must now ask what the effect of borrowing is. To analyze this

problem, let us assume that diversion does not occur, so in the first instance

there is no direct offset to the $ 100 in the form of a compensating drop in

private expenditures. Note that the government's borrowing to spend does not

alter the amount of money in private hands. The government borrows $ 100 with

its right hand from some individuals and hands the money with its left hand to

those individuals to whom its expenditures go. Different people hold the money

but the total amount of money held is unchanged.

The simple Keynesian analysis implicitly assumes that borrowing the

money does not have any effects on other spending. There are two extreme

circumstances under which this can occur. First, suppose people are utterly

indifferent to whether they hold bonds or money, so that bonds to get the $ 100

can be sold without having to offer a higher return to the buyer than such bonds

were yielding before. (Of course, $ 100 is so small an amount that it would in

practice have a negligible effect on the required rate of return, but the issue is

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one of principle whose practical effect can be seen by letting the $ 100 stand for

$ 100 million or $ 100 ten-million.) In Keynesian jargon, there is a "liquidity trap"

so people buy the bonds with "idle money." If this is not the case, and clearly it

cannot be indefinitely, then the government can sell the bonds only by offering a

higher rate of return on it. A higher rate will then have to be paid also by other

borrowers. This higher rate will in general discourage private spending on the

part of would-be borrowers. Here comes the second extreme circumstance under

which the simple Keynesian analysis will hold: if potential borrowers are so

stubborn about spending that no rise in interest rates however steep will cut

down their expenditures, or, in Keynesian jargon, if the marginal efficiency

schedule of investment is perfectly inelastic with respect to the interest rate.

I know of no established economist, no matter how much of a Keynesian

he may regard himself as being, who would regard either of these extreme

assumptions as holding currently, or as being capable of holding over any

considerable range of borrowing or rise in interest rates, or as having held

except under rather special circumstances in the past. Yet many an economist,

let alone non-economist, whether regarding himself as Keynesian or not, accepts

as valid the belief that a rise in governmental expenditures relative to tax

receipts, even when financed by borrowing, is necessarily expansionist, though

as we have seen, this belief implicitly requires one of these extreme

circumstances to hold.

If neither assumption holds, the rise in government expenditures will be

offset by a decline in private expenditures on the part either of those who lend

funds to the government, or of those who would otherwise have borrowed the

funds. How much of the rise in expenditures will be offset? This depends on the

holders of money. The extreme assumption, implicit in a rigid quantity theory of

money, is that the amount of money people want to hold depends, on the

average, only on their income and not on the rate of return that they can get on

bonds and similar securities. In this case, since the total stock of money is the

same before and after, the total money income will also have to be the same in

order to make people just satisfied to hold that money stock. This means that

interest rates will have to rise enough to choke off an amount of private

spending exactly equal to the increased public expenditure. In this extreme case,

there is no sense at all in which the government expenditures are expansionary.

Not even money income goes up, let alone real income. All that happens is that

government expenditures go up and private expenditures down.

I warn the reader that this is a highly simplified analysis. A full analysis

would require a lengthy textbook. But even this simplified analysis is enough to

demonstrate that any result is possible between a $ 300 rise in income and a

zero rise. The more stubborn consumers are with respect to how much they will

spend on consumption out of a given income, and the more stubborn purchasers

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of capital goods are with respect to how much they will spend on such goods

regardless of cost, the nearer the result will be to the Keynesian extreme of a $

300 rise. On the other side, the more stubborn money holders are with respect

to the ratio they wish to maintain between their cash balances and their income,

the closer the result will be to the rigid quantity theory extreme of no change in

income. In which of these respects the public is more stubborn is an empirical

question to be judged from the factual evidence, not something that can be

determined by reason alone.

Before the Great Depression of the 1930's, the bulk of economists would

unquestionably have concluded that the result would be nearer to no rise in

income than to a $ 300 rise. Since then, the bulk of economists would

unquestionably conclude the opposite. More recently, there has been a

movement back toward the earlier position. Sad to say, none of these shifts can

be said to be based on satisfactory evidence. They have been based rather on

intuitive judgments from crude experience.

In co-operation with some of my students, I have done some fairly

extensive empirical work, for the U.S. and other countries, to get some more

satisfactory evidence. 2 The results are striking. They strongly suggest that the

actual outcome will be closer to the quantity theory extreme than to the

Keynesian. The judgement that seems justified on the basis of this evidence is

that the assumed $ 100 increase in government expenditures can on the average

be expected to add just about $ 100 to income, sometimes less, sometimes

more. This means that a rise in government expenditures relative to income is

not expansionary in any relevant sense. It may add to money income but all of

this addition is absorbed by government expenditures. Private expenditures are

unchanged. Since prices are likely to rise in the process, or fall less than they

otherwise would, the effect is to leave private expenditures smaller in real terms.

Converse propositions hold for a decline in government expenditures.

These conclusions cannot of course be regarded as final. They are based

on the broadest and most comprehensive body of evidence I know about, but

that body of evidence still leaves much to be desired.

One thing is however clear. Whether the views so widely accepted about

the effects of fiscal policy be right or wrong, they are contradicted by at least

one extensive body of evidence. I know of no other coherent or organized body

of evidence justifying them. They are part of economic mythology, not the

demonstrated conclusions of economic analysis or quantitative studies. Yet they

have wielded immense influence in securing widespread public backing for far-

reaching governmental interference in economic life.

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X A Program for Monetary Stability, (New York: Fordham University Press, 1959),

p. 23. ”

2 Some of the results are contained in Milton Friedman and David Meiselman,

The Relative Stability of the Investment Multiplier and Monetary Velocity in the

United States, 18961958 (forthcoming publication of Commission on Money and

Credit).

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Chapter VI

The Role of Government in Education

Formal schooling is today paid for and almost entirely administered by

government bodies or non-profit institutions. This situation has developed

gradually and is now taken so much for granted that little explicit attention is any

longer directed to the reasons for the special treatment of schooling even in

countries that are predominantly free enterprise in organization and philosophy.

The result has been an indiscriminate extension of governmental responsibility.

In terms of the principles developed in chapter ii, governmental

intervention into education can be rationalized on two grounds. The first is the

existence of substantial "neighborhood effects," i.e., circumstances under which

the action of one individual imposes significant costs on other individuals for

which it is not feasible to make him compensate them, or yields significant gains

to other individuals for which it is not feasible to make them compensate him

circumstances that make voluntary exchange impossible. The second is the

paternalistic concern for children and other irresponsible individuals.

Neighborhood effects and paternalism have very different implications for (1)

general education for citizenship, and (2) specialized vocational education. The

grounds for governmental intervention are widely different in these two areas

and justify very different types of action.

One further preliminary remark: it is important to distinguish between

"schooling" and "education." Not all schooling is education nor all education,

schooling. The proper subject of concern is education. The activities of

government are mostly limited to schooling.

General Education for Citizenship

A stable and democratic society is impossible without a minimum degree

of literacy and knowledge on the part of most citizens and without widespread

acceptance of some common set of values. Education can contribute to both. In

consequence, the gain from the education of a child accrues not only to the child

or to his parents but also to other members of the society. The education of my

child contributes to your welfare by promoting a stable and democratic society. It

is not feasible to identify the particular individuals (or families) benefited and so

to charge for the services rendered. There is therefore a significant

"neighborhood effect."

What kind of governmental action is justified by this particular

neighborhood effect? The most obvious is to require that each child receive a

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minimum amount of schooling of a specified kind. Such a requirement could be

imposed upon the parents without further government action, just as owners of

buildings, and frequently of automobiles, are required to adhere to specified

standards to protect the safety of others. There is, however, a difference

between the two cases. Individuals who cannot pay the costs of meeting the

standards required for buildings or automobiles can generally divest themselves

of the property by selling it. The requirement can thus generally be enforced

without government subsidy. The separation of a child from a parent who cannot

pay for the minimum required schooling is clearly inconsistent with our reliance

on the family as the basic social unit and our belief in the freedom of the

individual. Moreover, it would be very likely to detract from his education for

citizenship in a free society.

If the financial burden imposed by such a schooling requirement could

readily be met by the great bulk of the families in a community, it might still be

both feasible and desirable to require the parents to meet the cost directly.

Extreme cases could be handled by special subsidy provisions for needy families.

There are many areas in the United States today where these conditions are

satisfied. In these areas, it would be highly desirable to impose the costs directly

on the parents. This would eliminate the governmental machinery now required

to collect tax funds from all residents during the whole of their lives and then pay

it back mostly to the same people during the period when their children are in

school. It would reduce the likelihood that governments would also administer

schools, a matter discussed further below. It would increase the likelihood that

the subsidy component of school expenditures would decline as the need for

such subsidies declined with increasing general levels of income. If, as now, the

government pays for all or most schooling, a rise in income simply leads to a still

larger circular flow of funds through the tax mechanism, and an expansion in the

role of the government. Finally, but by no means least, imposing the costs on the

parents would tend to equalize the social and private costs of having children

and so promote a better distribution of families by size . 1

Differences among families in resources and in number of children, plus

the imposition of a standard of schooling involving very sizable costs, make such

a policy hardly feasible in many parts of the United States. Both in such areas,

and in areas where such a policy would be feasible, government has instead

assumed the financial costs of providing schooling. It has paid, not only for the

minimum amount of schooling required of all, but also for additional schooling at

higher levels available to youngsters but not required of them. One argument for

both steps is the "neighborhood effects" discussed above. The costs are paid

because this is the only feasible means of enforcing the required minimum.

Additional schooling is financed because other people benefit from the schooling

of those of greater ability and interest, since this is a way of providing better

social and political leadership. The gain from these measures must be balanced

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against the costs, and there can be much honest difference of judgment about

how extensive a subsidy is justified. Most of us, however, would probably

conclude that the gains are sufficiently important to justify some government

subsidy.

These grounds justify government subsidy of only certain kinds of

schooling. To anticipate, they do not justify subsidizing purely vocational training

which increases the economic productivity of the student but does not train him

for either citizenship or leadership. It is extremely difficult to draw a sharp line

between the two types of schooling. Most general schooling adds to the

economic value of the studentindeed it is only in modern times and in a few

countries that literacy has ceased to have a marketable value. And much

vocational training broadens the student's outlook. Yet the distinction is

meaningful. Subsidizing the training of veterinarians, beauticians, dentists, and a

host of other specialists, as is widely done in the United States in governmentally

supported educational institutions, cannot be justified on the same grounds as

subsidizing elementary schools or, at a higher level, liberal arts colleges. Whether

it can be justified on quite different grounds will be discussed later in this

chapter.

The qualitative argument from "neighborhood effects" does not, of

course, determine the specific kinds of schooling that should be subsidized or by

how much they should be subsidized. The social gain presumably is greatest for

the lowest levels of schooling, where there is the nearest approach to unanimity

about content, and declines continuously as the level of schooling rises. Even this

statement cannot be taken completely for granted. Many governments

subsidized universities long before they subsidized lower schools. What forms of

education have the greatest social advantage and how much of the community's

limited resources should be spent on them must be decided by the judgment of

the community expressed through its accepted political channels. The aim of this

analysis is not to decide these questions for the community but rather to clarify

the issues involved in making a choice, in particular whether it is appropriate to

make the choice on a communal rather than individual basis.

As we have seen, both the imposition of a minimum required level of

schooling and the financing of this schooling by the state can be justified by the

"neighborhood effects" of schooling. A third step, namely the actual

administration of educational institutions by the government, the

"nationalization," as it were, of the bulk of the "education industry" is much more

difficult to justify on these, or, so far as I can see, any other, grounds. The

desirability of such nationalization has seldom been faced explicitly. Governments

have, in the main, financed schooling by paying directly the costs of running

educational institutions. Thus this step seemed required by the decision to

subsidize schooling. Yet the two steps could readily be separated. Governments

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could require a minimum level of schooling financed by giving parents vouchers

redeemable for a specified maximum sum per child per year if spent on

"approved" educational services. Parents would then be free to spend this sum

and any additional sum they themselves provided on purchasing educational

services from an "approved" institution of their own choice. The educational

services could be rendered by private enterprises operated for profit, or by non-

profit institutions. The role of the government would be limited to insuring that

the schools met certain minimum standards, such as the inclusion of a minimum

common content in their programs, much as it now inspects restaurants to

insure that they maintain minimum sanitary standards. An excellent example of a

program of this sort is the United States educational program for veterans after

World War II. Each veteran who qualified was given a maximum sum per year

that could be spent at any institution of his choice, provided it met certain

minimum standards. A more limited example is the provision in Britain whereby

local authorities pay the fees of some students attending non-state schools.

Another is the arrangement in France whereby the state pays part of the costs

for students attending non-state schools.

One argument for nationalizing schools resting on a "neighborhood effect"

is that it might otherwise be impossible to provide the common core of values

deemed requisite for social stability. The imposition of minimum standards on

privately conducted schools, as suggested above, might not be enough to

achieve this result. The issue can be illustrated concretely in terms of schools run

by different religious groups. Such schools, it can be argued, will instil sets of

values that are inconsistent with one another and with those instilled in non-

sectarian schools; in this way, they convert education into a divisive rather than

a unifying force.

Carried to its extreme, this argument would call not only for

governmentally administered schools, but also for compulsory attendance at

such schools. Existing arrangements in the United States and most other

Western countries are a halfway house. Governmentally administered schools are

available but not compulsory. However, the link between the financing of

schooling and its administration places other schools at a disadvantage: they get

the benefit of little or none of the governmental funds spent on schooling a

situation that has been the source of much political dispute, particularly in France

and at present in the United States. The elimination of this disadvantage might,

it is feared, greatly strengthen the parochial schools and so render the problem

of achieving a common core of values even more difficult.

Persuasive as this argument is, it is by no means clear that it is valid or

that denationalizing schooling would have the effects suggested. On grounds of

principle, it conflicts with the preservation of freedom itself. Drawing a line

between providing for the common social values required for a stable society, on

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the one hand, and indoctrination inhibiting freedom of thought and belief, on the

other is another of those vague boundaries that is easier to mention than to

define.

In terms of effects, denationalizing schooling would widen the range of

choice available to parents. If, as at present, parents can send their children to

public schools without special payment, very few can or will send them to other

schools unless they too are subsidized. Parochial schools are at a disadvantage in

not getting any of the public funds devoted to schooling, but they have the

compensating advantage of being run by institutions that are willing to subsidize

them and can raise funds to do so. There are few other sources of subsidies for

private schools. If present public expenditures on schooling were made available

to parents regardless of where they send their children, a wide variety of schools

would spring up to meet the demand. Parents could express their views about

schools directly by withdrawing their children from one school and sending them

to another, to a much greater extent than is now possible. In general, they can

now take this step only at considerable cost by sending their children to a private

school or by changing their residence. For the rest, they can express their views

only through cumbrous political channels. Perhaps a somewhat greater degree of

freedom to choose schools could be made available in a governmentally

administered system, but it would be difficult to carry this freedom very far in

view of the obligation to provide every child with a place. Here, as in other fields,

competitive enterprise is likely to be far more efficient in meeting consumer

demand than either nationalized enterprises or enterprises run to serve other

purposes. The final result may therefore be that parochial schools would decline

rather than grow in importance.

A related factor working in the same direction is the understandable

reluctance of parents who send their children to parochial schools to increase

taxes to finance higher public school expenditures. As a result, those areas

where parochial schools are important have great difficulty raising funds for

public schools. Insofar as quality is related to expenditure, as to some extent it

undoubtedly is, public schools tend to be of lower quality in such areas and

hence parochial schools are relatively more attractive.

Another special case of the argument that governmentally conducted

schools are necessary for education to be a unifying force is that private schools

would tend to exacerbate class distinctions. Given greater freedom about where

to send their children, parents of a kind would flock together and so prevent a

healthy intermingling of children from decidedly different backgrounds. Whether

or not this argument is valid in principle, it is not at all clear that the stated

results would follow. Under present arrangements, stratification of residential

areas effectively restricts the intermingling of children from decidedly different

backgrounds. In addition, parents are not now prevented from sending their

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children to private schools. Only a highly limited class can or does do so,

parochial schools aside, thus producing further stratification.

Indeed, this argument seems to me to point in almost the diametrically

opposite direction toward the denationalizing of schools. Ask yourself in what

respect the inhabitant of a low income neighborhood, let alone of a Negro

neighborhood in a large city, is most disadvantaged. If he attaches enough

importance to, say, a new automobile, he can, by dint of saving, accumulate

enough money to buy the same car as a resident of a high-income suburb. To do

so, he need not move to that suburb. On the contrary, he can get the money

partly by economizing on his living quarters. And this goes equally for clothes, or

furniture, or books, or what not. But let a poor family in a slum have a gifted

child and let it set such high value on his or her schooling that it is willing to

scrimp and save for the purpose. Unless it can get special treatment, or

scholarship assistance, at one of the very few private schools, the family is in a

very difficult position. The "good" public schools are in the high income

neighborhoods. The family might be willing to spend something in addition to

what it pays in taxes to get better schooling for its child. But it can hardly afford

simultaneously to move to the expensive neighborhood.

Our views in these respects are, I believe, still dominated by the small

town which had but one school for the poor and rich residents alike. Under such

circumstances, public schools may well have equalized opportunities. With the

growth of urban and suburban areas, the situation has changed drastically. Our

present school system, far from equalizing opportunity, very likely does the

opposite. It makes it all the harder for the exceptional few and it is they who are

the hope of the future to rise above the poverty of their initial state.

Another argument for nationalizing schooling is "technical monopoly." In

small communities and rural areas, the number of children may be too small to

justify more than one school of reasonable size, so that competition cannot be

relied on to protect the interests of parents and children. As in other cases of

technical monopoly, the alternatives are unrestricted private monopoly, state-

controlled private monopoly, and public operation a choice among evils. This

argument, though clearly valid and significant, has been greatly weakened in

recent decades by improvements in transportation and increasing concentration

of the population in urban communities.

The arrangement that perhaps comes closest to being justified by these

considerations at least for primary and secondary education is a combination of

public and private schools. Parents who choose to send their children to private

schools would be paid a sum equal to the estimated cost of educating a child in a

public school, provided that at least this sum was spent on education in an

approved school. This arrangement would meet the valid features of the

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"technical monopoly" argument. It would meet the just complaints of parents

that if they send their children to private non-subsidized schools they are

required to pay twice for education once in the form of general taxes and once

directly. It would permit competition to develop. The development and

improvement of all schools would thus be stimulated. The injection of

competition would do much to promote a healthy variety of schools. It would do

much, also, to introduce flexibility into school systems. Not least of its benefits

would be to make the salaries of school teachers responsive to market forces. It

would thereby give public authorities an independent standard against which to

judge salary scales and promote a more rapid adjustment to changes in

conditions of demand and supply.

It is widely urged that the great need in schooling is more money to build

more facilities and to pay higher salaries to teachers in order to attract better

teachers. This seems a false diagnosis. The amount of money spent on schooling

has been rising at an extraordinarily high rate, far faster than our total income.

Teachers' salaries have been rising far faster than returns in comparable

occupations. The problem is not primarily that we are spending too little money

though we may be but that we are getting so little per dollar spent. Perhaps the

amounts of money spent on magnificent structures and luxurious grounds at

many schools are properly classified as expenditures on schooling. It is hard to

accept them equally as expenditures on education. And this is equally clear with

respect to courses in basket weaving, social dancing, and the numerous other

special subjects that do such credit to the ingenuity of educators. I hasten to add

that there can be no conceivable objection to parents' spending their own money

on such frills if they wish. That is their business. The objection is to using money

raised by taxation imposed on parents and non-parents alike for such purposes.

Wherein are the "neighborhood effects" that justify such use of tax money?

A major reason for this kind of use of public money is the present system

of combining the administration of schools with their financing. The parent who

would prefer to see money used for better teachers and texts rather than

coaches and corridors has no way of expressing this preference except by

persuading a majority to change the mixture for all. This is a special case of the

general principle that a market permits each to satisfy his own taste effective

proportional representation; whereas the political process imposes conformity. In

addition, the parent who would like to spend some extra money on his child's

education is greatly limited. He cannot add something to the amount now being

spent to school his child and transfer his child to a correspondingly more costly

school. If he does transfer his child, he must pay the whole cost and not simply

the additional cost. He can only spend extra money easily on extra-curricular

activities dancing lessons, music lessons, etc. Since the private outlets for

spending more money on schooling are so blocked, the pressure to spend more

on the education of children manifests itself in ever higher public expenditures

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on items ever more tenuously related to the basic justification for governmental

intervention into schooling.

As this analysis implies, the adoption of the suggested arrangements

might well mean smaller governmental expenditures on schooling, yet higher

total expenditures. It would enable parents to buy what they want more

efficiently and thereby lead them to spend more than they now do directly and

indirectly through taxation. It would prevent parents from being frustrated in

spending more money on schooling by both the present need for conformity in

how the money is spent and by the understandable reluctance on the part of

persons not currently having children in school, and especially those who will not

in the future have them in school, to impose higher taxes on themselves for

purposes often far removed from education as they understand the term . 2

With respect to teachers' salaries, the major problem is not that they are

too low on the average they may well be too high on the average but that they

are too uniform and rigid. Poor teachers are grossly overpaid and good teachers

grossly underpaid. Salary schedules tend to be uniform and determined far more

by seniority, degrees received, and teaching certificates acquired than by merit.

This, too, is largely a result of the present system of governmental

administration of schools and becomes more serious as the unit over which

governmental control is exercised becomes larger. Indeed, this very fact is a

major reason why professional educational organizations so strongly favor

broadening the unit from the local school district to the state, from the state to

the federal government. In any bureaucratic, essentially civil-service

organization, standard salary scales are almost inevitable; it is next to impossible

to simulate competition capable of providing wide differences in salaries

according to merit. The educators, which means the teachers themselves, come

to exercise primary control. The parent or local community comes to exercise

little control. In any area, whether it be carpentry or plumbing or teaching, the

majority of workers favor standard salary scales and oppose merit differentials,

for the obvious reason that the specially talented are always few. This is a

special case of the general tendency for people to seek to collude to fix prices,

whether through unions or industrial monopolies. But collusive agreements will

generally be destroyed by competition unless the government enforces them, or

at least renders them considerable support.

If one were to seek deliberately to devise a system of recruiting and

paying teachers calculated to repel the imaginative and daring and self-confident

and to attract the dull and mediocre and uninspiring, he could hardly do better

than imitate the system of requiring teaching certificates and enforcing standard

salary structures that has developed in the larger city and state-wide systems. It

is perhaps surprising that the level of ability in elementary and secondary school

teaching is as high as it is under these circumstances. The alternative system

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would resolve these problems and permit competition to be effective in

rewarding merit and attracting ability to teaching.

Why has governmental intervention in schooling in the United States

developed along the lines it has? I do not have the detailed knowledge of

educational history that would be required to answer this question definitively. A

few conjectures may nonetheless be useful to suggest the kinds of

considerations that may alter the appropriate social policy. I am by no means

sure that the arrangements I now propose would in fact have been desirable a

century ago. Before the extensive growth in transportation, the "technical

monopoly" argument was much stronger. Equally important, the major problem

in the United States in the nineteenth and early twentieth century was not to

promote diversity but to create the core of common values essential to a stable

society. Great streams of immigrants were flooding the United States from all

over the world, speaking different languages and observing diverse customs. The

"melting pot" had to introduce some measure of conformity and loyalty to

common values. The public school had an important function in this task, not

least by imposing English as a common language. Under the alternative voucher

scheme, the minimum standards imposed on schools to qualify for approval

could have included the use of English. But it might well have been more difficult

to insure that this requirement was imposed and satisfied in a private school

system. I do not mean to conclude that the public school system was definitely

preferable to the alternative, but only that a far stronger case could have been

made for it then than now. Our problem today is not to enforce conformity; it is

rather that we are threatened with an excess of conformity. Our problem is to

foster diversity, and the alternative would do this far more effectively than a

nationalized school system.

Another factor that may have been important a century ago was the

combination of the general disrepute of cash grants to individuals ("handouts"),

with the absence of an efficient administrative machinery to handle the

distribution of vouchers and check their use. Such machinery is a phenomenon of

modern times that has come to full flower with the enormous extension of

personal taxation and of social security programs. In its absence, the

administration of schools may have been regarded as the only possible way to

finance education.

As some of the examples cited above (England and France) suggest, some

features of the proposed arrangements are present in existing educational

systems. And there has been strong and, I believe, increasing pressure for

arrangements of this kind in most Western countries. This is perhaps partly

explained by modern developments in governmental administrative machinery

that facilitate such arrangements.

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Although many administrative problems would arise in changing over from

the present to the proposed system and in its administration, these seem neither

insoluble nor unique. As in the denationalization of other activities, existing

premises and equipment could be sold to private enterprises that wanted to

enter the field. Thus, there would be no waste of capital in the transition. Since

governmental units, at least in some areas, would continue to administer

schools, the transition would be gradual and easy. The local administration of

schooling in the United States and some other countries would similarly facilitate

the transition, since it would encourage experimentation on a small scale.

Difficulties would doubtless arise in determining eligibility for grants from a

particular governmental unit, but this is identical with the existing problem of

determining which unit is obligated to provide schooling facilities for a particular

child. Differences in size of grants would make one area more attractive than

another just as differences in the quality of schooling now have the same effect.

The only additional complication is a possibly greater opportunity for abuse

because of the greater freedom to decide where to educate children. Supposed

difficulty of administration is a standard defense of the status quo against any

proposed change; in this particular case, it is an even weaker defense than usual

because existing arrangements must master not only the major problems raised

by the proposed arrangements but also the additional problems raised by the

administration of schools as a governmental function.

Schooling at College and University Level

The preceding discussion is concerned mostly with primary and secondary

schooling. For higher schooling, the case for nationalization on grounds either of

neighborhood effects or of technical monopoly is even weaker. For the lowest

levels of schooling, there is considerable agreement, approximating unanimity,

on the appropriate content of an educational program for citizens of a democracy

the three R's cover most of the ground. At successively higher levels, there is

less and less agreement. Surely, well below the level of the American college,

there is insufficient agreement to justify imposing the views of a majority, much

less a plurality, on all. The lack of agreement may, indeed, extend so far as to

cast doubts on the appropriateness even of subsidizing schooling at this level; it

surely goes far enough to undermine any case for nationalization on the grounds

of providing a common core of values. There can hardly be any question of

"technical monopoly" at this level, in view of the distances that individuals can

and do go to attend institutions of higher learning.

Governmental institutions play a smaller role in the United States in higher

schooling than at primary and secondary levels. Yet they grew greatly in

importance, certainly until the 1920's, and now account for more than half of the

students attending colleges and universities. 3 One of the main reasons for their

growth was their relative cheapness; most state and municipal colleges and

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universities charge much lower tuition fees than private universities can afford to

charge. Private universities have in consequence had serious financial problems,

and have quite properly complained of "unfair" competition. They have wanted

to maintain their independence from government, yet at the same time have felt

driven by financial pressure to seek government aid.

The preceding analysis suggests the lines along which a satisfactory

solution can be sought. Public expenditures on higher schooling can be justified

as a means of training youngsters for citizenship and for community leadership

though I hasten to add that the large fraction of current expenditure that goes

for strictly vocational training cannot be justified in this way, or indeed, as we

shall see, in any other. Restricting the subsidy to schooling obtained at a state-

administered institution cannot be justified on any grounds. Any subsidy should

be granted to individuals to be spent at institutions of their own choosing,

provided only that the schooling is of a kind that it is desired to subsidize. Any

government schools that are retained should charge fees covering educational

costs and so compete on an equal level with non-government-supported

schools . 4 The resulting system would follow in its broad outlines the

arrangements adopted in the United States after World War II for financing the

education of veterans, except that the funds would presumably come from the

states rather than the federal government.

The adoption of such arrangements would make for more effective

competition among various types of schools and for a more efficient utilization of

their resources. It would eliminate the pressure for direct government assistance

to private colleges and universities and thus preserve their full independence and

diversity at the same time as it enabled them to grow relative to state

institutions. It might also have the ancillary advantage of causing scrutiny of the

purposes for which subsidies are granted. The subsidization of institutions rather

than of people has led to an indiscriminate subsidization of all activities

appropriate for such institutions, rather than of the activities appropriate for the

state to subsidize. Even cursory examination suggests that while the two classes

of activities overlap, they are far from identical.

The equity argument for the alternative arrangement is particularly clear

at college and university levels because of the existence of a large number and

variety of private schools. The state of Ohio, for example, says to its citizens: "If

you have a youngster who wants to go to college, we shall automatically grant

him or her a sizable four-year scholarship, provided that he or she can satisfy

rather minimal education requirements, and provided further that he or she is

smart enough to choose to go to the University of Ohio. If your youngster wants

to go, or you want him or her to go, to Oberlin College, or Western Reserve

University, let alone to Yale, Harvard, Northwestern, Beloit, or the University of

Chicago, not a penny for him." How can such a program be justified? Would it

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not be far more equitable, and promote a higher standard of scholarship, to

devote such money as the state of Ohio wished to spend on higher education to

scholarships tenable at any college or university and to require the University of

Ohio to compete on equal terms with other colleges and universities? 5

Vocational and Professional Schooling

Vocational and professional schooling has no neighborhood effects of the

kind attributed above to general education. It is a form of investment in human

capital precisely analogous to investment in machinery, buildings, or other forms

of non-human capital. Its function is to raise the economic productivity of the

human being. If it does so, the individual is rewarded in a free enterprise society

by receiving a higher return for his services than he would otherwise be able to

command. 6 This difference in return is the economic incentive to invest capital

whether in the form of a machine or a human being. In both cases, extra returns

must be balanced against the costs of acquiring them. For vocational schooling,

the major costs are the income foregone during the period of training, interest

lost by postponing the beginning of the earning period, and special expenses of

acquiring the training such as tuition fees and expenditures on books and

equipment. For physical capital, the major costs are the expense of constructing

the capital equipment and the interest foregone during construction. In both

cases, an individual presumably regards the investment as desirable if the extra

returns, as he views them, exceed the extra costs, as he views them. 7 In both

cases, if the individual undertakes the investment and if the state neither

subsidizes the investment nor taxes the return, the individual (or his parents,

sponsor, or benefactor) in general bears all the extra costs and receives all the

extra returns: there are no obvious unborne costs or unappropriable returns that

tend to make private incentives diverge systematically from those that are

socially appropriate.

If capital were as readily available for investment in human beings as for

investment in physical assets, whether through the market or through direct

investment by the individuals concerned, or their parents or benefactors, the rate

of return on capital would tend to be roughly equal in the two fields. If it were

higher on non-human capital, parents would have an incentive to buy such

capital for their children instead of investing a corresponding sum in vocational

training, and conversely. In fact, however, there is considerable empirical

evidence that the rate of return on investment in training is very much higher

than the rate of return on investment in physical capital. This difference suggests

the existence of underinvestment in human capital 8

This underinvestment in human capital presumably reflects an

imperfection in the capital market. Investment in human beings cannot be

financed on the same terms or with the same ease as investment in physical

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capital. It is easy to see why. If a fixed money loan is made to finance

investment in physical capital, the lender can get some security for his loan in

the form of a mortgage or residual claim to the physical asset itself, and he can

count on realizing at least part of his investment in case of default by selling the

physical asset. If he makes a comparable loan to increase the earning power of a

human being, he clearly cannot get any comparable security. In a non-slave

state, the individual embodying the investment cannot be bought and sold. Even

if he could, the security would not be comparable. The productivity of the

physical capital does not in general depend on the co-operativeness of the

original borrower. The productivity of the human capital quite obviously does. A

loan to finance the training of an individual who has no security to offer other

than his future earnings is therefore a much less attractive proposition than a

loan to finance the erection of a building: the security is less, and the cost of

subsequent collection of interest and principal is very much greater.

A further complication is introduced by the inappropriateness of fixed

money loans to finance investment in training. Such an investment necessarily

involves much risk. The average expected return may be high, but there is wide

variation about the average. Death or physical incapacity is one obvious source

of variation but this is probably much less important than differences in ability,

energy, and good fortune. Consequently if fixed money loans were made, and

were secured only by expected future earnings, a considerable fraction would

never be repaid. In order to make such loans attractive to lenders, the nominal

interest rate charged on all loans would have to be sufficiently high to

compensate for the capital losses on the defaulted loans. The high nominal

interest rate would both conflict with usury laws and make the loans unattractive

to borrowers . 9 The device adopted to meet the corresponding problem for other

risky investments is equity investment plus limited liability on the part of the

shareholders. The counterpart for education would be to "buy" a share in an

individual's earning prospects; to advance him the funds needed to finance his

training on condition that he agree to pay the lender a specified fraction of his

future earnings. In this way, a lender would get back more than his initial

investment from relatively successful individuals, which would compensate for

the failure to recoup his original investment from the unsuccessful.

There seems no legal obstacle to private contracts of this kind, even

though they are economically equivalent to the purchase of a share in an

individual's earning capacity and thus to partial slavery. One reason why such

contracts have not become common, despite their potential profitability to both

lender and borrower, is presumably the high costs of administering them, given

the freedom of individuals to move from one place to another, the need for

getting accurate income statements, and the long period over which the

contracts would run. These costs would presumably be particularly high for

investment on a small scale with a wide geographical spread of the individuals

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financed. Such costs may well be the primary reason that this type of investment

has never developed under private auspices.

It seems highly likely, however, that a major role has also been played by

the cumulative effect of the novelty of the idea, the reluctance to think of

investment in human beings as strictly comparable to investment in physical

assets, the resultant likelihood of irrational public condemnation of such

contracts, even if voluntarily entered into, and legal and conventional limitations

on the kind of investments that may be made by the financial intermediaries that

would be best suited to engage in such investments, namely, life insurance

companies. The potential gains, particularly to early entrants, are so great that it

would be worth incurring extremely heavy administrative costs . 10

Whatever the reason, an imperfection of the market has led to

underinvestment in human capital. Government intervention might therefore be

rationalized on grounds both of "technical monopoly," insofar as the obstacle to

the development of such investment has been administrative costs, and of

improving the operation of the market, insofar as it has been simply market

frictions and rigidities.

If government does intervene, how should it do so? One obvious form of

intervention, and the only form that has so far been taken, is outright

government subsidy of vocational or professional schooling financed out of

general revenues. This form seems clearly inappropriate. Investment should be

carried to the point at which the extra return repays the investment and yields

the market rate of interest on it. If the investment is in a human being, the extra

return takes the form of a higher payment for the individual's services than he

could otherwise command. In a private market economy, the individual would

get this return as his personal income. If the investment were subsidized, he

would have borne none of the costs. In consequence, if subsidies were given to

all who wished to get the training, and could meet minimum quality standards,

there would tend to be overinvestment in human beings, since individuals would

have an incentive to get the training so long as it yielded any extra return over

private costs, even if the return were insufficient to repay the capital invested, let

alone yield any interest on it. To avoid such overinvestment, government would

have to restrict the subsidies. Even apart from the difficulty of calculating the

"correct" amount of investment, this would involve rationing in some essentially

arbitrary way the limited amount of investment among more claimants than

could be financed. Those fortunate enough to get their training subsidized would

receive all the returns from the investment whereas the costs would be borne by

the taxpayers in general an entirely arbitrary and almost surely perverse

redistribution of income.

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The desideratum is not to redistribute income but to make capital

available at comparable terms for human and physical investment. Individuals

should bear the costs of investment in themselves and receive the rewards. They

should not be prevented by market imperfections from making the investment

when they are willing to bear the costs. One way to achieve this result is for

government to engage in equity investment in human beings. A governmental

body could offer to finance or help finance the training of any individual who

could meet minimum quality standards. It would make available a limited sum

per year for a specified number of years, provided the funds were spent on

securing training at a recognized institution. The individual in return would agree

to pay to the government in each future year a specified percentage of his

earnings in excess of a specified sum for each $ 1,000 that he received from the

government. This payment could easily be combined with payment of income tax

and so involve a minimum of additional administrative expense. The base sum

should be set equal to estimated average earnings without the specialized

training; the fraction of earnings paid should be calculated so as to make the

whole project self-financing. In this way, the individuals who received the

training would in effect bear the whole cost. The amount invested could then be

determined by individual choice. Provided this was the only way in which

government financed vocational or professional training, and provided the

calculated earnings reflected all relevant returns and costs, the free choice of

individuals would tend to produce the optimum amount of investment.

The second proviso is unfortunately not likely to be fully satisfied because

of the impossibility of including non-pecuniary returns mentioned above. In

practice, therefore, investment under the plan would still be somewhat too small

and would not be distributed in the optimum manner. 11

For several reasons, it would be preferable for private financial institutions

and non-profit institutions such as foundations and universities to develop this

plan. Because of the difficulties involved in estimating the base earnings and the

fraction of earnings in excess of the base to be paid to the government, there is

great danger that the scheme would turn into a political football. Information on

existing earnings in various occupations would provide only a rough

approximation to the values that would render the project self-financing. In

addition, the base earnings and the fraction should vary from individual to

individual in accordance with any differences in expected earning capacity that

can be predicted in advance, just as life insurance premiums vary among groups

that have different life expectancy.

Insofar as administrative expense is the obstacle to the development of

such a plan on a private basis, the appropriate unit of government to make funds

available is the federal government rather than smaller units. Any one state

would have the same costs as an insurance company, say, in keeping track of

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the people whom it had financed. These would be minimized though not

completely eliminated for the federal government. An individual who migrated to

another country, for example, might still be legally or morally obligated to pay

the agreed-on share of his earnings, yet it might be difficult and expensive to

enforce the obligation. Highly successful people might therefore have an

incentive to migrate. A similar problem arises, of course, under the income tax,

and to a very much greater extent. This and other administrative problems of

conducting the scheme on a federal level, while doubtless troublesome in detail,

do not seem serious. The serious problem is the political one already mentioned:

how to prevent the scheme from becoming a political football and in the process

being converted from a self-financing project to a means of subsidizing

vocational education.

But if the danger is real, so is the opportunity. Existing imperfections in

the capital market tend to restrict the more expensive vocational and

professional training to individuals whose parents or benefactors can finance the

training required. They make such individuals a "non-competing" group sheltered

from competition by the unavailability of the necessary capital to many able

individuals. The result is to perpetuate inequalities in wealth and status. The

development of arrangements such as those outlined above would make capital

more widely available and would thereby do much to make equality of

opportunity a reality, to diminish inequalities of income and wealth, and to

promote the full use of our human resources. And it would do so not by

impeding competition, destroying incentive, and dealing with symptoms, as

would result from the outright redistribution of income, but by strengthening

competition, making incentives effective, and eliminating the causes of

inequality.

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1 It is by no means so fantastic as may appear that such a step would noticeably

affect the size of families. For example, one explanation of the lower birth rate

among higher than among lower socio-economic groups may well be that

children are relatively more expensive to the former, thanks in considerable

measure to the higher standards of schooling they maintain, the costs of which

they bear.

2 A striking example of the same effect in another field is the British National

Health Service. In a careful and penetrating study, D. S. Lees establishes rather

conclusively that, "Far from being extravagant, expenditure on NHS has been

less than consumers would probably have chosen to spend in a free market. The

record of hospital building in particular has been deplorable." "Health Through

Choice," Hobart Paper 14 (London: Institute of Economic Affairs, 1961), p. 58.

3 See George J. Stigler, Employment and Compensation in Education

("Occasional Paper" No. 33, [New York: National Bureau of Economic Research,

1950]), p. 33.

4 I am abstracting from expenditures on basic research. I have interpreted

schooling narrowly so as to exclude considerations that would open up an unduly

wide field.

5 I have used Ohio rather than Illinois, because since the article of which this

chapter is a revision was written (1953), Illinois has adopted a program going

part-way along this line by providing scholarships tenable at private colleges and

universities in Illinois. California has done the same. Virginia has adopted a

similar program at lower levels for a very different reason, to avoid racial

integration. The Virginia case is discussed in chapter vii.

6 The increased return may be only partly in a monetary form; it may also consist

of non-pecuniary advantages attached to the occupation for which the vocational

training fits the individual. Similarly, the occupation may have non-pecuniary

disadvantages, which would have to be reckoned among the costs of the

investment.

7 For a more detailed and precise statement of the considerations entering into

the choice of an occupation, see Milton Friedman and Simon Kuznets, Income

from Independent Professional Practice (New York: National Bureau of Economic

Research, 1945), pp. 8195, 11837.

8 See G. S. Becker, "Underinvestment in College Education?" American Economic

Review, Proceedings L (1960), 35664; T. W. Schultz, "Investment in human

Capital," American Economic Review, LXI (1961), 117.

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9

Despite these obstacles to fixed money loans, I am told that they have been a

very common means of financing education in Sweden, where they have

apparently been available at moderate rates of interest. Presumably a proximate

explanation is a smaller dispersion of income among university graduates than in

the United States. But this is no ultimate explanation and may not be the only or

major reason for the difference in practice. Further study of Swedish and similar

experience is highly desirable to test whether the reasons given above are

adequate to explain the absence in the United States and other countries of a

highly developed market in loans to finance vocational education, or whether

there may not be other obstacles that could be removed more easily.

In recent years, there has been an encouraging development in the U.S.

of private loans to college students. The main development has been stimulated

by United Student Aid Funds, a non-profit institution which underwrites loans

made by individual banks.

10 It is amusing to speculate on how the business could be done and on some

ancillary methods of profiting from it. The initial entrants would be able to

choose the very best investments, by imposing very high quality standards on

the individuals they were willing to finance. If they did so, they would increase

the profitability of their investment by getting public recognition of the superior

quality of the individuals they financed: the legend, "Training financed by XYZ

Insurance Company" could be made into an assurance of quality (like "Approved

by Good Housekeeping") that would attract custom. All sorts of other common

services might be rendered by the XYZ company to "its" physicians, lawyers,

dentists, and so on.

11 I am indebted to Harry G. Johnson and Paul W. Cook, Jr., for suggesting the

inclusion of this qualification. For a fuller discussion of the role of non-pecuniary

advantages and disadvantages in determining earnings in different pursuits, see

Friedman and Kuznets, loc. cit.

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Chapter VI I

Capitalism and Discrimination

It is a striking historical fact that the development of capitalism has been

accompanied by a major reduction in the extent to which particular religious,

racial, or social groups have operated under special handicaps in respect of their

economic activities; have, as the saying goes, been discriminated against. The

substitution of contract arrangements for status arrangements was the first step

toward the freeing of the serfs in the Middle Ages. The preservation of Jews

through the Middle Ages was possible because of the existence of a market

sector in which they could operate and maintain themselves despite official

persecution. Puritans and Quakers were able to migrate to the New World

because they could accumulate the funds to do so in the market despite

disabilities imposed on them in other aspects of their life. The Southern states

after the Civil War took many measures to impose legal restrictions on Negroes.

One measure which was never taken on any scale was the establishment of

barriers to the ownership of either real or personal property. The failure to

impose such barriers clearly did not reflect any special concern to avoid

restrictions on Negroes. It reflected rather, a basic belief in private property

which was so strong that it overrode the desire to discriminate against Negroes.

The maintenance of the general rules of private property and of capitalism have

been a major source of opportunity for Negroes and have permitted them to

make greater progress than they otherwise could have made. To take a more

general example, the preserves of discrimination in any society are the areas

that are most monopolistic in character, whereas discrimination against groups of

particular color or religion is least in those areas where there is the greatest

freedom of competition.

As pointed out in chapter i, one of the paradoxes of experience is that, in

spite of this historical evidence, it is precisely the minority groups that have

frequently furnished the most vocal and most numerous advocates of

fundamental alterations in a capitalist society. They have tended to attribute to

capitalism the residual restrictions they experience rather than to recognize that

the free market has been the major factor enabling these restrictions to be as

small as they are.

We have already seen how a free market separates economic efficiency

from irrelevant characteristics. As noted in chapter i, the purchaser of bread does

not know whether it was made from wheat grown by a white man or a Negro, by

a Christian or a Jew. In consequence, the producer of wheat is in a position to

use resources as effectively as he can, regardless of what the attitudes of the

community may be toward the color, the religion, or other characteristics of the

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people he hires. Furthermore, and perhaps more important, there is an economic

incentive in a free market to separate economic efficiency from other

characteristics of the individual. A businessman or an entrepreneur who

expresses preferences in his business activities that are not related to productive

efficiency is at a disadvantage compared to other individuals who do not. Such

an individual is in effect imposing higher costs on himself than are other

individuals who do not have such preferences. Hence, in a free market they will

tend to drive him out.

This same phenomenon is of much wider scope. It is often taken for

granted that the person who discriminates against others because of their race,

religion, color, or whatever, incurs no costs by doing so but simply imposes costs

on others. This view is on a par with the very similar fallacy that a country does

not hurt itself by imposing tariffs on the products of other countries. 1 Both are

equally wrong. The man who objects to buying from or working alongside a

Negro, for example, thereby limits his range of choice. He will generally have to

pay a higher price for what he buys or receive a lower return for his work. Or,

put the other way, those of us who regard color of skin or religion as irrelevant

can buy some things more cheaply as a result.

As these comments perhaps suggest, there are real problems in defining

and interpreting discrimination. The man who exercises discrimination pays a

price for doing so. He is, as it were, "buying" what he regards as a "product." It

is hard to see that discrimination can have any meaning other than a "taste" of

others that one does not share. We do not regard it as "discrimination" or at

least not in the same invidious sense if an individual is willing to pay a higher

price to listen to one singer than to another, although we do if he is willing to

pay a higher price to have services rendered to him by a person of one color

than by a person of another. The difference between the two cases is that in the

one case we share the taste, and in the other case we do not. Is there any

difference in principle between the taste that leads a householder to prefer an

attractive servant to an ugly one and the taste that leads another to prefer a

Negro to a white or a white to a Negro, except that we sympathize and agree

with the one taste and may not with the other? I do not mean to say that all

tastes are equally good.

On the contrary, I believe strongly that the color of a man's skin or the

religion of his parents is, by itself, no reason to treat him differently; that a man

should be judged by what he is and what he does and not by these external

characteristics. I deplore what seem to me the prejudice and narrowness of

outlook of those whose tastes differ from mine in this respect and I think the less

of them for it. But in a society based on free discussion, the appropriate recourse

is for me to seek to persuade them that their tastes are bad and that they should

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change their views and their behavior, not to use coercive power to enforce my

tastes and my attitudes on others.

Fair Employment Practices Legislation

Fair employment practice commissions that have the task of preventing

"discrimination" in employment by reason of race, color, or religion have been

established in a number of states. Such legislation clearly involves interference

with the freedom of individuals to enter into voluntary contracts with one

another. It subjects any such contract to approval or disapproval by the state.

Thus it is directly an interference with freedom of the kind that we would object

to in most other contexts. Moreover, as is true with most other interferences

with freedom, the individuals subjected to the law may well not be those whose

actions even the proponents of the law wish to control.

For example, consider a situation in which there are grocery stores serving

a neighborhood inhabited by people who have a strong aversion to being waited

on by Negro clerks. Suppose one of the grocery stores has a vacancy for a clerk

and the first applicant qualified in other respects happens to be a Negro. Let us

suppose that as a result of the law the store is required to hire him. The effect of

this action will be to reduce the business done by this store and to impose losses

on the owner. If the preference of the community is strong enough, it may even

cause the store to close. When the owner of the store hires white clerks in

preference to Negroes in the absence of the law, he may not be expressing any

preference or prejudice or taste of his own. Fie may simply be transmitting the

tastes of the community. Fie is, as it were, producing the services for the

consumers that the consumers are willing to pay for. Nonetheless, he is harmed,

and indeed may be the only one harmed appreciably, by a law which prohibits

him from engaging in this activity, that is, prohibits him from pandering to the

tastes of the community for having a white rather than a Negro clerk. The

consumers, whose preferences the law is intended to curb, will be affected

substantially only to the extent that the number of stores is limited and hence

they must pay higher prices because one store has gone out of business. This

analysis can be generalized. In a very large fraction of cases, employers are

transmitting the preference of either their customers or their other employees

when they adopt employment policies that treat factors irrelevant to technical

physical productivity as relevant to employment. Indeed, employers typically

have an incentive, as noted earlier, to try to find ways of getting around the

preferences of their consumers or of their employees if such preferences impose

higher costs upon them.

The proponents of FEPC argue that interference with the freedom of

individuals to enter into contracts with one another with respect to employment

is justified because the individual who refuses to hire a Negro instead of a white,

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when both are equally qualified in terms of physical productive capacity, is

harming others, namely, the particular color or religious group whose

employment opportunity is limited in the process. This argument involves a

serious confusion between two very different kinds of harm. One kind is the

positive harm that one individual does another by physical force, or by forcing

him to enter into a contract without his consent. An obvious example is the man

who hits another over the head with a blackjack. A less obvious example is

stream pollution discussed in chapter ii. The second kind is the negative harm

that occurs when two individuals are unable to find mutually acceptable

contracts, as when I am unwilling to buy something that someone wants to sell

me and therefore make him worse off than he would be if I bought the item. If

the community at large has a preference for blues singers rather than for opera

singers, they are certainly increasing the economic well-being of the first relative

to the second. If a potential blues singer can find employment and a potential

opera singer cannot, this simply means that the blues singer is rendering

services which the community regards as worth paying for whereas the potential

opera singer is not. The potential opera singer is "harmed" by the community's

taste. He would be better off and the blues singer "harmed" if the tastes were

the reverse. Clearly, this kind of harm does not involve any involuntary exchange

or an imposition of costs or granting of benefits to third parties. There is a strong

case for using government to prevent one person from imposing positive harm,

which is to say, to prevent coercion. There is no case whatsoever for using

government to avoid the negative kind of "harm." On the contrary, such

government intervention reduces freedom and limits voluntary co-operation.

FEPC legislation involves the acceptance of a principle that proponents

would find abhorrent in almost every other application. If it is appropriate for the

state to say that individuals may not discriminate in employment because of

color or race or religion, then it is equally appropriate for the state, provided a

majority can be found to vote that way, to say that individuals must discriminate

in employment on the basis of color, race or religion. The Hitler Nuremberg laws

and the laws in the Southern states imposing special disabilities upon Negroes

are both examples of laws similar in principle to FEPC. Opponents of such laws

who are in favor of FEPC cannot argue that there is anything wrong with them in

principle, that they involve a kind of state action that ought not to be permitted.

They can only argue that the particular criteria used are irrelevant. They can only

seek to persuade other men that they should use other criteria instead of these.

If one takes a broad sweep of history and looks at the kind of things that

the majority will be persuaded of if each individual case is to be decided on its

merits rather than as part of a general principle, there can be little doubt that the

effect of a widespread acceptance of the appropriateness of government action

in this area would be extremely undesirable, even from the point of view of those

who at the moment favor FEPC. If, at the moment, the proponents of FEPC are

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in a position to make their views effective, it is only because of a constitutional

and federal situation in which a regional majority in one part of the country may

be in a position to impose its views on a majority in another part of the country.

As a general rule, any minority that counts on specific majority action to

defend its interests is short-sighted in the extreme. Acceptance of a general self-

denying ordinance applying to a class of cases may inhibit specific majorities

from exploiting specific minorities. In the absence of such a self-denying

ordinance, majorities can surely be counted on to use their power to give effect

to their preferences, or if you will, prejudices, not to protect minorities from the

prejudices of majorities.

To put the matter in another and perhaps more striking way, consider an

individual who believes that the present pattern of tastes is undesirable and who

believes that Negroes have less opportunity than he would like to see them have.

Suppose he puts his beliefs into practice by always choosing the Negro applicant

for a job whenever there are a number of applicants more or less equally

qualified in other respects. Under present circumstances should he be prevented

from doing so? Clearly the logic of the FEPC is that he should be.

The counterpart to fair employment in the area where these principles

have perhaps been worked out more than any other, namely, the area of

speech, is "fair speech" rather than free speech. In this respect the position of

the American Civil Liberties Union seems utterly contradictory. It favors both free

speech and fair employment laws. One way to state the justification for free

speech is that we do not believe that it is desirable that momentary majorities

decide what at any moment shall be regarded as appropriate speech. We want a

free market in ideas, so that ideas get a chance to win majority or near-

unanimous acceptance, even if initially held only by a few. Precisely the same

considerations apply to employment or more generally to the market for goods

and services. Is it any more desirable that momentary majorities decide what

characteristics are relevant to employment than what speech is appropriate?

Indeed, can a free market in ideas long be maintained if a free market in goods

and services is destroyed? The ACLU will fight to the death to protect the right of

a racist to preach on a street corner the doctrine of racial segregation. But it will

favor putting him in jail if he acts on his principles by refusing to hire a Negro for

a particular job.

As already stressed, the appropriate recourse of those of us who believe

that a particular criterion such as color is irrelevant is to persuade our fellows to

be of like mind, not to use the coercive power of the state to force them to act in

accordance with our principles. Of all groups, the ACLU should be the first both

to recognize and proclaim that this is so.

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Right-to-Work Laws

Some states have passed so-called "right-to-work" laws. These are laws

which make it illegal to require membership in a union as a condition of

employment.

The principles involved in right-to-work laws are identical with those

involved in FEPC. Both interfere with the freedom of the employment contract, in

the one case by specifying that a particular color or religion cannot be made a

condition of employment; in the other, that membership in a union cannot be.

Despite the identity of principle, there is almost 100 per cent divergence of views

with respect to the two laws. Almost all who favor FEPC oppose right to work;

almost all who favor right to work oppose FEPC. As a liberal, I am opposed to

both, as I am equally to laws outlawing the so-called "yellow-dog" contract (a

contract making non-membership in a union a condition of employment).

Given competition among employers and employees, there seems no

reason why employers should not be free to offer any terms they want to their

employees. In some cases employers find that employees prefer to have part of

their remuneration take the form of amenities such as baseball fields or play

facilities or better rest facilities rather than cash. Employers then find that it is

more profitable to offer these facilities as part of their employment contract

rather than to offer higher cash wages. Similarly, employers may offer pension

plans, or require participation in pension plans, and the like. None of this

involves any interference with the freedom of individuals to find employment. It

simply reflects an attempt by employers to make the characteristics of the job

suitable and attractive to employees. So long as there are many employers, all

employees who have particular kinds of wants will be able to satisfy them by

finding employment with corresponding employers. Under competitive conditions

the same thing would be true with respect to the closed shop. If in fact some

employees would prefer to work in firms that have a closed shop and others in

firms that have an open shop, there would develop different forms of

employment contracts, some having the one provision, others the other

provision.

As a practical matter, of course, there are some important differences

between FEPC and right to work. The differences are the presence of monopoly

in the form of union organizations on the employee side and the presence of

federal legislation in respect of labor unions. It is doubtful that in a competitive

labor market, it would in fact ever be profitable for employers to offer a closed

shop as a condition of employment. Whereas unions may frequently be found

without any strong monopoly power on the side of labor, a closed shop almost

never is. It is almost always a symbol of monopoly power.

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The coincidence of a closed shop and labor monopoly is not an argument

for a right-to-work law. It is an argument for action to eliminate monopoly power

regardless of the particular forms and manifestations which it takes. It is an

argument for more effective and widespread antitrust action in the labor field.

Another special feature that is important in practice is the conflict between

federal and state law and the existence at the moment of a federal law which

applies to all the states and which leaves a loophole for the individual state only

through the passage of a right-to-work law. The optimum solution would be to

have the federal law revised. The difficulty is that no individual state is in a

position to bring this about and yet people within an individual state might wish

to have a change in the legislation governing union organization within their

state. The right-to-work law may be the only effective way in which this can be

done and therefore the lesser of evils. Partly,

I suppose, because I am inclined to believe that a right-to-work law will

not in and of itself have any great effect on the monopoly power of the unions, I

do not accept this justification for it. The practical arguments seem to me much

too weak to outweigh the objection of principle.

Segregation in Schooling

Segregation in schooling raises a particular problem not covered by the

previous comments for one reason only. The reason is that schooling is, under

present circumstances, primarily operated and administered by government. This

means that government must make an explicit decision. It must either enforce

segregation or enforce integration. Both seem to me bad solutions. Those of us

who believe that color of skin is an irrelevant characteristic and that it is

desirable for all to recognize this, yet who also believe in individual freedom, are

therefore faced with a dilemma. If one must choose between the evils of

enforced segregation or enforced integration, I myself would find it impossible

not to choose integration.

The preceding chapter, written initially without any regard at all to the

problem of segregation or integration, gives the appropriate solution that permits

the avoidance of both evils a nice illustration of how arrangements designed to

enhance freedom in general cope with problems of freedom in particular. The

appropriate solution is to eliminate government operation of the schools and

permit parents to choose the kind of school they want their children to attend. In

addition, of course, we should all of us, insofar as we possibly can, try by

behavior and speech to foster the growth of attitudes and opinions that would

lead mixed schools to become the rule and segregated schools the rare

exception.

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If a proposal like that of the preceding chapter were adopted, it would

permit a variety of schools to develop, some all white, some all Negro, some

mixed. It would permit the transition from one collection of schools to another

hopefully to mixed schools to be gradual as community attitudes changed. It

would avoid the harsh political conflict that has been doing so much to raise

social tensions and disrupt the community. It would in this special area, as the

market does in general, permit co-operation without conformity . 2

The state of Virginia has adopted a plan having many features in common

with that outlined in the preceding chapter. Though adopted for the purpose of

avoiding compulsory integration, I predict that the ultimate effects of the law will

be very different after all, the difference between result and intention is one of

the primary justifications of a free society; it is desirable to let men follow the

bent of their own interests because there is no way of predicting where they will

come out. Indeed, even in the early stages there have been surprises. I have

been told that one of the first requests for a voucher to finance a change of

school was by a parent transferring a child from a segregated to an integrated

school. The transfer was requested not for this purpose but simply because the

integrated school happened to be the better school educationally. Looking

further ahead, if the voucher system is not abolished, Virginia will provide an

experiment to test the conclusions of the preceding chapter. If those conclusions

are right, we should see a flowering of the schools available in Virginia, with an

increase in their diversity, a substantial if not spectacular rise in the quality of the

leading schools, and a later rise in the quality of the rest under the impetus of

the leaders.

On the other side of the picture, we should not be so naive as to suppose

that deep-seated values and beliefs can be uprooted in short measure by law. I

live in Chicago. Chicago has no law compelling segregation. Its laws require

integration. Yet in fact the public schools of Chicago are probably as thoroughly

segregated as the schools of most Southern cities. There is almost no doubt at

all that if the Virginia system were introduced in Chicago, the result would be an

appreciable decrease in segregation, and a great widening in the opportunities

available to the ablest and most ambitious Negro youth.

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1 In a brilliant and penetrating analysis of some economic issues involved in

discrimination, Gary Becker demonstrates that the problem of discrimination is

almost identical in its logical structure with that of foreign trade and tariffs. See

G. S. Becker, The Economics of Discrimination (Chicago: University of Chicago

Press, 1957).

2 To avoid misunderstanding, it should be noted explicitly that in speaking of the

proposal in the preceding chapter, I am taking it for granted that the minimum

requirements imposed on schools in order that vouchers be usable do not include

whether the school is segregated or not.

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Chapter VI 1 1

Monopoly and the Social Responsibility of Business

and Labor

Competition has two very different meanings. In ordinary discourse,

competition means personal rivalry, with one individual seeking to outdo his

known competitor. In the economic world, competition means almost the

opposite. There is no personal rivalry in the competitive market place. There is

no personal higgling. The wheat farmer in a free market does not feel himself in

personal rivalry with, or threatened by, his neighbor, who is, in fact, his

competitor. The essence of a competitive market is its impersonal character. No

one participant can determine the terms on which other participants shall have

access to goods or jobs. All take prices as given by the market and no individual

can by himself have more than a negligible influence on price though all

participants together determine price by the combined effect of their separate

actions.

Monopoly exists when a specific individual or enterprise has sufficient

control over a particular product or service to determine significantly the terms

on which other individuals shall have access to it. In some ways, monopoly

comes closer to the ordinary concept of competition since it does involve

personal rivalry.

Monopoly raises two classes of problems for a free society. First, the

existence of monopoly means a limitation on voluntary exchange through a

reduction in the alternatives available to individuals. Second, the existence of

monopoly raises the issue of the "social responsibility," as it has come to be

called, of the monopolist. The participant in a competitive market has no

appreciable power to alter terms of exchange; he is hardly visible as a separate

entity; hence it is hard to argue that he has any "social responsibility" except

that which is shared by all citizens to obey the law of the land and to live

according to his lights. The monopolist is visible and has power. It is easy to

argue that he should discharge his power not solely to further his own interests

but to further socially desirable ends. Yet the widespread application of such a

doctrine would destroy a free society.

Of course, competition is an ideal type, like a Euclidean line or point. No

one has ever seen a Euclidean line which has zero width and depth yet we all

find it useful to regard many a Euclidean volume such as a surveyor's string as a

Euclidean line. Similarly, there is no such thing as "pure" competition. Every

producer has some effect, however tiny, on the price of the product he

produces. The important issue for understanding and for policy is whether this

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effect is significant or can properly be neglected, as the surveyor can neglect the

thickness of what he calls a "line." The answer must, of course, depend on the

problem. But as I have studied economic activities in the United States, I have

become increasingly impressed with how wide is the range of problems and

industries for which it is appropriate to treat the economy as if it were

competitive.

The issues raised by monopoly are technical and cover a field in which I

have no special competence. In consequence, this chapter is limited to a fairly

cursory survey of some of the broader issues: the extent of monopoly, sources of

monopoly, appropriate government policy, and the social responsibility of

business and labor.

The Extent of Monopoly

There are three important areas of monopoly requiring separate

consideration: monopoly in industry, monopoly in labor, and governmentally

produced monopoly.

1. Monopoly in Industry The most important fact about enterprise

monopoly is its relative unimportance from the point of view of the economy as a

whole. There are some four million separate operating enterprises in the United

States; some four hundred thousand new ones are born each year; a somewhat

smaller number die each year. Nearly one fifth of the working population is self-

employed. In almost any industry that one can mention, there are giants and

pygmies side by side.

Beyond these general impressions, it is difficult to cite a satisfactory

objective measure of the extent of monopoly and of competition. The main

reason is one already noted: these concepts as used in economic theory are ideal

constructs designed to analyze particular problems rather than to describe

existing situations. As a result, there can be no clear-cut determination of

whether a particular enterprise or industry is to be regarded as monopolistic or

as competitive. The difficulty of assigning precise meanings to such terms leads

to much misunderstanding. The same word is used to refer to different things,

depending on the background of experience in terms of which the state of

competition is judged. Perhaps the most striking example is the extent to which

an American student will describe as monopolistic, arrangements that a

European would regard as highly competitive. As a result, Europeans interpreting

American literature and discussion in terms of the meaning attached to the terms

competition and monopoly in Europe tend to believe that there is a much greater

degree of monopoly in the United States than in fact exists.

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A number of studies, particularly by G. Warren Nutter and George J.

Stigler, have tried to classify industries as monopolistic, workably competitive,

and governmentally operated or supervised, and to trace changes over time in

these categories. 1 They conclude that, as of 1939, roughly one quarter of the

economy could be regarded as governmentally operated or supervised. Of the

three-quarters remaining, at most one-quarter and perhaps as little as 15

percent can be regarded as monopolistic, at least three-quarters and perhaps as

much as 85 percent, as competitive. The governmentally operated or supervised

sector has of course grown greatly over the past half-century or so. Within the

private sector, on the other hand, there appears not to have been any tendency

for the scope of monopoly to have increased and it may well have decreased.

There is, I suspect, a widespread impression that monopoly is both far

more important than these estimates suggest and has been growing steadily

over time. One reason for this mistaken impression is the tendency to confuse

absolute and relative size. As the economy has grown, enterprises have become

larger in absolute size. This has been taken to mean also that they account for a

larger fraction of the market, whereas the market may have grown even faster.

A second reason is that monopoly is more newsworthy and leads to more

attention than competition. If individuals were asked to list the major industries

in the United States, almost all would include automobile production, few would

include wholesale trade. Yet wholesale trade is twice as important as automobile

production. Wholesale trade is highly competitive, hence draws little attention to

itself. Few people could name any leading enterprises in wholesale trade, though

there are some that are very large in absolute size. Automobile production, while

in certain respects highly competitive, has many fewer firms and is certainly

closer to monopoly. Everyone can name the leading firms producing

automobiles. To cite one other striking example: domestic service is a vastly

more important industry than the telegraph and telephone industry. A third

reason is the general bias and tendency to overemphasize the importance of the

big versus the small, of which the preceding point is only a particular

manifestation. Finally, the main characteristic of our society is taken to be its

industrial character. This leads to overemphasis of the manufacturing sector of

the economy, which accounts for only about one-quarter of output or

employment. And monopoly is far more prevalent in manufacturing than in other

sectors of the economy.

The over-estimation of the importance of monopoly is accompanied, for

much the same reasons, by an over-estimation of the importance of those

technological changes that promote monopoly by comparison with those that

extend competition. For example, the spread of mass production has been

greatly stressed. The developments in transportation and communication that

have promoted competition by reducing the importance of local regional markets

and widening the scope within which competition could take place have been

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given much less attention. The growing concentration of the automobile industry

is a commonplace; growth of the trucking industry which reduces dependence on

large railroads passes with little notice; so does the declining concentration in the

steel industry.

2. Monopoly in Labor There is a similar tendency to overestimate the

importance of monopoly on the side of labor. Labor unions include roughly a

quarter of the working population and this greatly overestimates the importance

of unions on the structure of wages. Many unions are utterly ineffective. Even

the strong and powerful unions have only a limited effect on the wage structure.

It is even clearer for labor than for industry why there is a strong tendency to

overestimate the importance of monopoly. Given a labor union, any wage

increase will come through the union, even though it may not be a consequence

of the union organization. The wages of domestic servants have risen very

greatly in recent years. Had there been a union of domestic servants, the

increase would have come through the union and would have been attributed to

it.

This is not to say that unions are unimportant. Like enterprise monopoly,

they play a significant and meaningful role making many wage rates different

from what the market alone would establish. It would be as much a mistake to

underestimate as to overestimate their importance. I once made a rough

estimate that because of unions something like 10 to 15 per cent of the working

population has had its wage rates raised by something like 10 to 15 per cent.

This means that something like 85 or 90 per cent of the working population has

had its wage rates reduced by some 4 per cent. 2 Since I made these estimates,

much more detailed studies have been done by others. My impression is that

they yield results of much the same order of magnitude.

If unions raise wage rates in a particular occupation or industry, they

necessarily make the amount of employment available in that occupation or

industry less than it otherwise would be just as any higher price cuts down the

amount purchased. The effect is an increased number of persons seeking other

jobs, which forces down wages in other occupations. Since unions have generally

been strongest among groups that would have been high-paid anyway, their

effect has been to make high-paid workers higher paid at the expense of lower-

paid workers. Unions have therefore not only harmed the public at large and

workers as a whole by distorting the use of labor; they have also made the

incomes of the working class more unequal by reducing the opportunities

available to the most disadvantaged workers.

In one respect, there is an important difference between labor and

enterprise monopoly. While there seems not to have been any upward trend in

the importance of enterprise monopoly over the past half-century, there certainly

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has been in the importance of labor monopoly. Labor unions grew notably in

importance during World War I, declined during the 'twenties and early 'thirties,

then took an enormous leap forward during the New Deal period. They

consolidated their gains during and after World War II. More recently, they have

been just holding their own or even declining. The decline does not reflect a

decline within particular industries or occupations but rather a declining

importance of those industries or occupations in which unions are strong relative

to those in which unions are weak.

The distinction I have been drawing between labor monopoly and

enterprise monopoly is in one respect too sharp. To some extent, labor unions

have served as a means of enforcing monopoly in the sale of a product. The

clearest example is in coal. The Guffey Coal Act was an attempt to provide legal

support for a price-fixing cartel of coal-mine operators. When, in the mid-thirties,

this Act was declared unconstitutional, John L. Lewis and the United Mine

Workers stepped into the breach. By calling strikes or work stoppages whenever

the amount of coal above the ground got so large as to threaten to force down

prices, Lewis controlled output and thereby prices with the unspoken co-

operation of the industry. The gains from this cartel management were divided

between the coal mine operators and the miners. The gain to the miners was in

the form of higher wage rates, which of course meant fewer miners employed.

Hence only those miners who retained employment shared the cartel gains and

even they took a large part of the gain in the form of greater leisure. The

possibility of the unions playing this role derives from their exemption from the

Sherman Antitrust Act. Many other unions have taken advantage of this

exemption and are better interpreted as enterprises selling the services of

cartellizing an industry than as labor organizations. The Teamster's Union is

perhaps the most notable.

3. Government and Government-Supported Monopoly In the United

States, direct government monopoly in the production of goods for sale is not

very extensive. The post office, electric power production, as by TVA and other

publicly owned power stations; the provision of highway services, sold indirectly

through the gasoline tax or directly by tolls, and municipal water and similar

plants are the main examples. In addition, with so large a defense, space, and

research budget as we now have, the federal government has become

essentially the only purchaser of the products of many enterprises and whole

industries. This raises very serious problems for the preservation of a free

society, but not of a kind that are best considered under the heading of

"monopoly."

The use of government to establish, support and enforce cartel and

monopoly arrangements among private producers has grown much more rapidly

than direct government monopoly and is currently far more important. The

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Interstate Commerce Commission is an early example, and it has extended its

scope from railroads to trucking and other means of transport. The agricultural

program is undoubtedly the most notorious. It is essentially a governmentally

enforced cartel. Other examples are the Federal Communications Commission,

with its control over radio and television; the Federal Power Commission, with its

control over oil and gas moving in interstate trade; the Civil Aeronautics Board,

with its control over airlines; and the enforcement by the Federal Reserve Board

of maximum interest rates that banks may pay on time deposits, and the legal

prohibition of the payment of interest on demand deposits.

These examples are on a federal level. In addition, there has been a great

proliferation of similar developments on a state and local level. The Texas

Railroad Commission, which so far as I know, has nothing to do with railroads,

enforces output restrictions on oil wells, by limiting the number of days when

wells may produce. It does so in the name of conservation but in fact for the

purpose of controlling prices. More recently, it has been strongly assisted by

federal import quotas on oil. Keeping oil wells idle most of the time to keep up

prices seems to me featherbedding of precisely the same kind as paying coal

firemen on diesel locomotives for being idle. Yet some representatives of

business who are loudest in their condemnation of labor featherbedding as a

violation of free enterprise notably the oil industry itself are deafeningly silent

about featherbedding in oil.

Licensure provisions, discussed in the next chapter, are another example

of governmentally created and supported monopoly on a state level. Restrictions

on the number of taxicabs that can be operated exemplify similar restriction on a

local level. In New York, a medallion signifying the right to operate an

independent cab now sells for something like $ 20,000 to $ 25,000; in

Philadelphia, for $ 15,000. Another example on a local level is the enactment of

building codes, ostensibly designed for public safety, but in fact generally under

the control of local building trade unions or associations of private contractors.

Such restrictions are numerous and apply to a considerable variety of activities

on both city and state levels. All constitute arbitrary limitations on the ability of

individuals to enter into voluntary exchanges with one another. They

simultaneously restrict freedom and promote the waste of resources.

A kind of governmentally created monopoly very different in principle from

those so far considered is the grant of patents to inventors and copyrights to

authors. These are different, because they can equally be regarded as defining

property rights. In a literal sense, if I have a property right to a particular piece

of land, I can be said to have a monopoly with respect to that piece of land

defined and enforced by the government. With respect to inventions and

publications, the problem is whether it is desirable to establish an analogous

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property right. This problem is part of the general need to use government to

establish what shall and what shall not be regarded as property.

In both patents and copyrights, there is clearly a strong prima facie case

for establishing property rights. Unless this is done, the inventor will find it

difficult or impossible to collect a payment for the contribution his invention

makes to output. He will, that is, confer benefits on others for which he cannot

be compensated. Hence he will have no incentive to devote the time and effort

required to produce the invention. Similar considerations apply to the writer.

At the same time, there are costs involved. For one thing, there are many

"inventions" that are not patentable. The "inventor" of the supermarket, for

example, conferred great benefits on his fellowmen for which he could not

charge them. Insofar as the same kind of ability is required for the one kind of

invention as for the other, the existence of patents tends to divert activity to

patentable inventions. For another, trivial patents, or patents that would be of

dubious legality if contested in court, are often used as a device for maintaining

private collusive arrangements that would otherwise be more difficult or

impossible to maintain.

These are very superficial comments on a difficult and important problem.

Their aim is not to suggest any specific answer but only to show why patents

and copyrights are in a different class from the other governmentally supported

monopolies and to illustrate the problem of social policy that they raise. One

thing is clear. The specific conditions attached to patents and copyrights for

example, the grant of patent protection for seventeen years rather than some

other period are not a matter of principle. They are matters of expediency to be

determined by practical considerations. I am myself inclined to believe that a

much shorter period of patent protection would be preferable. But this is a casual

judgment on a subject on which there has been much detailed study and on

which much more is needed. Hence, it is deserving of little confidence.

The Sources of Monopoly

There are three major sources of monopoly: "technical" considerations,

direct and indirect governmental assistance, and private collusion.

1. Technical Considerations as pointed out in chapter ii, monopoly arises

to some extent because technical considerations make it more efficient or

economical to have a single enterprise rather than many. The most obvious

example is a telephone system, water system, and the like in an individual

community. There is unfortunately no good solution for technical monopoly.

There is only a choice among three evils: private unregulated monopoly, private

monopoly regulated by the state, and government operation.

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It seems impossible to state as a general proposition that one of these

evils is uniformly preferable to another. As stated in chapter ii, the great

disadvantage of either governmental regulation or governmental operation of

monopoly is that it is exceedingly difficult to reverse. In consequence, I am

inclined to urge that the least of the evils is private unregulated monopoly

wherever this is tolerable. Dynamic changes are highly likely to undermine it and

there is at least some chance that these will be allowed to have their effect. And

even in the short run, there is generally a wider range of substitutes than there

seems to be at first blush, so private enterprises are fairly narrowly limited in the

extent to which it is profitable to keep prices above cost. Moreover, as we have

seen, the regulatory agencies often tend themselves to fall under the control of

the producers and so prices may not be any lower with regulation than without

regulation.

Fortunately, the areas in which technical considerations make monopoly a

likely or a probable outcome are fairly limited. They would offer no serious threat

to the preservation of a free economy if it were not for the tendency of

regulation, introduced on this ground, to spread to situations in which it is not so

justified.

2. Direct and Indirect Government Assistance Probably the most important

source of monopoly power has been government assistance, direct and indirect.

Numerous examples of reasonably direct government assistance have been cited

above. The indirect assistance to monopoly consists of measures taken for other

purposes which have as a largely unintended effect the imposition of limitations

on potential competitors of existing firms. Perhaps the three clearest examples

are tariffs, tax legislation, and law enforcement and legislation with respect to

labor disputes.

Tariffs have of course been imposed largely to "protect" domestic

industries, which means to impose handicaps on potential competitors. They

always interfere with the freedom of individuals to engage in voluntary

exchange. After all, the liberal takes the individual, not the nation or citizen of a

particular nation, as his unit. Hence he regards it just as much a violation of

freedom if citizens of the United States and Switzerland are prevented from

consummating an exchange that would be mutually advantageous as if two

citizens of the United States are prevented from doing so. Tariffs need not

produce monopoly. If the market for the protected industry is sufficiently large

and technical conditions permit many firms, there can be effective competition

domestically in the protected industry, as in the United States in textiles. Clearly,

however, tariffs do foster monopoly. It is far easier for a few firms than for many

to collude to fix prices, and it is generally easier for enterprises in the same

country to collude than for enterprises in different countries. Britain was

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protected by free trade from widespread monopoly during the nineteenth and

early twentieth centuries, despite the relatively small size of her domestic market

and the large scale of many firms. Monopoly has become a much more serious

problem in Britain since free trade was abandoned, first after World War I and

then more extensively in the early 1930's.

The effects of tax legislation have been even more indirect yet not less

important. A major element has been the linkage of the corporate and individual

income tax combined with the special treatment of capital gains under the

individual income tax. Let us suppose a corporation earns an income of $ 1

million over and above corporate taxes. If it pays the whole million dollars to its

stockholders as dividends, they must include it as part of their taxable income.

Suppose they would, on the average, have to pay 50 per cent of this additional

income as income tax. They would then have available only $ 500, 000 to spend

on consumption or to save and invest. If instead the corporation pays no cash

dividends to its stockholders, it has the whole million dollars to invest internally.

Such reinvestment will tend to raise the capital value of its stock, stockholders

who would have saved the funds if distributed can simply hold the stock and

postpone all taxes until they sell the stock. They, as well as others who sell at an

earlier date to realize income for consumption, will pay tax at capital gains rates,

which are lower than rates on regular income.

This tax structure encourages retention of corporate earnings. Even if the

return that can be earned internally is appreciably less than the return that the

stockholder himself could earn by investing the funds externally, it may pay to

invest internally because of the tax saving. This leads to a waste of capital, to its

use for less productive rather than more productive purposes. It has been a

major reason for the post-World-War-l I tendency toward horizontal

diversification as firms have sought outlets for their earnings. It is also a great

source of strength for established corporations relative to new enterprises. The

established corporations can be less productive than new enterprises, yet their

stockholders have an incentive to invest in them rather than to have the income

paid out so that they can invest it in new enterprises through the capital market.

A major source of labor monopoly has been government assistance.

Licensure provisions, building codes, and the like, discussed above have been

one source. Legislation granting special immunities to labor unions, such as

exemption from the anti-trust laws, restrictions on union responsibility, the right

to appear before special tribunals, and so on, are a second source. Perhaps of

equal or greater importance than either is a general climate of opinion and law

enforcement applying different standards to actions taken in the course of a

labor dispute than to the same actions under other circumstances. If men turn

cars over, or destroy property, out of sheer wickedness or in the course of

exacting private vengeance, not a hand will be lifted to protect them from the

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legal consequences. If they commit the same acts in the course of labor dispute,

they may well get off scot free. Union actions involving actual or potential

physical violence or coercion could hardly take place if it were not for the

unspoken acquiescence of the authorities.

3. Private Collusion The final source of monopoly is private collusion. As

Adam Smith says, "People of the same trade seldom meet together, even for

merriment and diversion, but the conversation ends in a conspiracy against the

public, or in some contrivance to raise prices." 3 Such collusion or private cartel

arrangements are therefore constantly arising. However, they are generally

unstable and of brief duration unless they can call government to their

assistance. The establishment of the cartel, by raising prices, makes it more

profitable for outsiders to enter the industry. Moreover, since the higher price

can be established only by the participants' restricting their output below the

level that they would like to produce at the fixed price, there is an incentive for

each one separately to undercut the price in order to expand output. Each one,

of course, hopes that the others will abide by the agreement. It takes only one

or at most a few "chiselers" who are indeed public benefactors to break the

cartel. In the absence of government assistance in enforcing the cartel, they are

almost sure to succeed fairly promptly.

The major role of our antitrust laws has been to inhibit such private

collusion. Their main contribution in this respect has been less through actual

prosecutions than by their indirect effects. They have ruled out the obvious

collusive devices such as the public get-together for this specific purposeand

have therefore made collusion more expensive. More important, they have

reaffirmed common law doctrine that combinations in restraint of trade are

unenforceable in the courts. In various European countries, the courts will

enforce an agreement entered into by a group of enterprises to sell only through

a joint selling agency, committing the enterprises to pay specified penalties if

they violate the agreement. In the United States, such an agreement would not

be enforceable in the courts. This difference is one of the major reasons why

cartels have been more stable and widespread in European countries than in the

United States.

Appropriate Government Policy

The first and most urgent necessity in the area of government policy is

the elimination of those measures which directly support monopoly, whether

enterprise monopoly or labor monopoly, and an even-handed enforcement of the

laws on enterprises and labor unions alike. Both should be subjected to the anti-

trust laws; both should be treated alike with respect to laws about the

destruction of property and about interference with private activities.

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Beyond this, the most important and effective step toward the reduction

of monopoly power would be an extensive reform of the tax laws. The corporate

tax should be abolished. Whether this is done or not, corporations should be

required to attribute to individual stockholders earnings which are not paid out as

dividends. That is, when the corporation sends out a dividend check, it should

also send a statement saying, "In addition to this dividend of cents per share,

your corporation also earned cents per share which was reinvested." The

individual stockholder should then be required to report the attributed but

undistributed earnings on his tax return as well as the dividend. Corporations

would still be free to plough back as much as they wish, but they would have no

incentive to do so except the proper incentive that they could earn more

internally than the stockholder could earn externally. Few measures would do

more to invigorate capital markets, to stimulate enterprise, and to promote

effective competition.

Of course, so long as the individual income tax is as highly graduated as it

is now, there is strong pressure to find devices to evade its impact. In this way

as well as directly, the highly graduated income tax constitutes a serious

impediment to the efficient use of our resources. The appropriate solution is the

drastic scaling down of the higher rates, combined with an elimination of the

avoidance devices that have been incorporated in the law.

Social Responsibility of Business and Labor

The view has been gaining widespread acceptance that corporate officials

and labor leaders have a "social responsibility" that goes beyond serving the

interest of their stockholders or their members. This view shows a fundamental

misconception of the character and nature of a free economy. In such an

economy, there is one and only one social responsibility of businessto use its

resources and engage in activities designed to increase its profits so long as it

stays within the rules of the game, which is to say, engages in open and free

competition, without deception or fraud. Similarly, the "social responsibility" of

labor leaders is to serve the interests of the members of their unions. It is the

responsibility of the rest of us to establish a framework of law such that an

individual in pursuing his own interest is, to quote Adam Smith again, "led by an

invisible hand to promote an end which was no part of his intention. Nor is it

always the worse for the society that it was no part of it. By pursuing his own

interest, he frequently promotes that of the society more effectually than when

he really intends to promote it. I have never known much good done by those

who affected to trade for the public good ." 4

Few trends could so thoroughly undermine the very foundations of our

free society as the acceptance by corporate officials of a social responsibility

other than to make as much money for their stockholders as possible. This is a

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fundamentally subversive doctrine. If businessmen do have a social responsibility

other than making maximum profits for stockholders, how are they to know what

it is? Can self-selected private individuals decide what the social interest is? Can

they decide how great a burden they are justified in placing on themselves or

their stockholders to serve that social interest? Is it tolerable that these public

functions of taxation, expenditure, and control be exercised by the people who

happen at the moment to be in charge of particular enterprises, chosen for those

posts by strictly private groups? If businessmen are civil servants rather than the

employees of their stockholders then in a democracy they will, sooner or later,

be chosen by the public techniques of election and appointment.

And long before this occurs, their decision-making power will have been

taken away from them. A dramatic illustration was the cancellation of a steel

price increase by U.S. Steel in April 1962 through the medium of a public display

of anger by President Kennedy and threats of reprisals on levels ranging from

anti-trust suits to examination of the tax reports of steel executives. This was a

striking episode because of the public display of the vast powers concentrated in

Washington. We were all made aware of how much of the power needed for a

police state was already available. It illustrates the present point as well. If the

price of steel is a public decision, as the doctrine of social responsibility declares,

then it cannot be permitted to be made privately.

The particular aspect of the doctrine which this example illustrates, and

which has been most prominent recently, is an alleged social responsibility of

business and labor to keep prices and wage rates down in order to avoid price

inflation. Suppose that at a time when there was upward pressure on prices

ultimately of course reflecting an increase in the stock of money every

businessman and labor leader were to accept this responsibility and suppose all

could succeed in keeping any price from rising, so we had voluntary price and

wage control without open inflation. What would be the result? Clearly product

shortages, labor shortages, gray markets, black markets. If prices are not

allowed to ration goods and workers, there must be some other means to do so.

Can the alternative rationing schemes be private? Perhaps for a time in a small

and unimportant area. But if the goods involved are many and important, there

will necessarily be pressure, and probably irresistible pressure, for governmental

rationing of goods, a governmental wage policy, and governmental measures for

allocating and distributing labor.

Price controls, whether legal or voluntary, if effectively enforced would

eventually lead to the destruction of the free-enterprise system and its

replacement by a centrally controlled system. And it would not even be effective

in preventing inflation. History offers ample evidence that what determines the

average level of prices and wages is the amount of money in the economy and

not the greediness of businessmen or of workers. Governments ask for the self-

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restraint of business and labor because of their inability to manage their own

affairs which includes the control of money and the natural human tendency to

pass the buck.

One topic in the area of social responsibility that I feel duty-bound to

touch on, because it affects my own personal interests, has been the claim that

business should contribute to the support of charitable activities and especially to

universities. Such giving by corporations is an inappropriate use of corporate

funds in a free-enterprise society.

The corporation is an instrument of the stockholders who own it. If the

corporation makes a contribution, it prevents the individual stockholder from

himself deciding how he should dispose of his funds. With the corporation tax

and the deductibility of contributions, stockholders may of course want the

corporation to make a gift on their behalf, since this would enable them to make

a larger gift. The best solution would be the abolition of the corporate tax. But so

long as there is a corporate tax, there is no justification for permitting deductions

for contributions to charitable and educational institutions. Such contributions

should be made by the individuals who are the ultimate owners of property in

our society.

People who urge extension of the deductibility of this kind of corporate

contribution in the name of free enterprise are fundamentally working against

their own interest. A major complaint made frequently against modern business

is that it involves the separation of ownership and control that the corporation

has become a social institution that is a law unto itself, with irresponsible

executives who do not serve the interests of their stockholders. This charge is

not true. But the direction in which policy is now moving, of permitting

corporations to make contributions for charitable purposes and allowing

deductions for income tax, is a step in the direction of creating a true divorce

between ownership and control and of undermining the basic nature and

character of our society. It is a step away from an individualistic society and

toward the corporate state.

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1 G. Warren Nutter, The Extent of Enterprise Monopoly in the United States,

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Five Lectures on Economic Problems (London; Longmans, Green and Co., 1949),

pp. 4665.

2 "Some Comments on the Significance of Labor Unions for Economic Policy," in

David McCord Wright (ed.), The Impact of the Union (New York: Harcourt,

Brace, 1951), pp. 20434.

3 The Wealth of Nations (1776), Bk. I, chap, x, Pt. II (Cannan ed. London, 1930),

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4 1 bid, Bk. IV, chapter ii, p. 421.

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Chapter I X

Occupational Licensure

The overthrow of the medieval guild system was an indispensable early

step in the rise of freedom in the Western world. It was a sign of the triumph of

liberal ideas, and widely recognized as such, that by the mid-nineteenth century,

in Britain, the United States, and to a lesser extent on the continent of Europe,

men could pursue whatever trade or occupation they wished without the by-

your-leave of any governmental or quasi-governmental authority. In more recent

decades, there has been a retrogression, an increasing tendency for particular

occupations to be restricted to individuals licensed to practice them by the state.

These restrictions on the freedom of individuals to use their resources as

they wish are important in their own right. In addition, they provide still a

different class of problems to which we can apply the principles developed in the

first two chapters.

I shall discuss first the general problem and then a particular example,

restrictions on the practice of medicine. The reason for choosing medicine is that

it seems desirable to discuss the restrictions for which the strongest case can be

made there is not much to be learned by knocking down straw men. I suspect

that most people, possibly even most liberals, believe that it is desirable to

restrict the practice of medicine to people who are licensed by the state. I agree

that the case for licensure is stronger for medicine than for most other fields. Yet

the conclusions I shall reach are that liberal principles do not justify licensure

even in medicine and that in practice the results of state licensure in medicine

have been undesirable.

Ubiquity of Governmental Restrictions on Economic Activities Men

May Engage in

Licensure is a special case of a much more general and exceedingly

widespread phenomenon, namely, edicts that individuals may not engage in

particular economic activities except under conditions laid down by a constituted

authority of the state. Medieval guilds were a particular example of an explicit

system for specifying which individuals should be permitted to follow particular

pursuits. The Indian caste system is another example. To a considerable extent

in the caste system, to a lesser extent in the guilds, the restrictions were

enforced by general social customs rather than explicitly by government.

A widespread notion about the caste system is that every person's

occupation is completely determined by the caste into which he is born. It is

obvious to an economist that this is an impossible system, since it prescribes a

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rigid distribution of persons among occupations determined entirely by birthrates

and not at all by conditions of demand. Of course, this is not the way the system

worked. What was true, and to some measure still is, was that a limited number

of occupations were reserved to members of certain castes, but not every

member of those castes followed those occupations. There were some general

occupations, such as general agricultural work, which members of various castes

might engage in. These permitted an adjustment of the supply of people in

different occupations to the demand for their services.

Currently, tariffs, fair-trade laws, import quotas, production quotas, trade

union restrictions on employment and so on are examples of similar phenomena.

In all these cases, governmental authority determines the conditions under which

particular individuals can engage in particular activities, which is to say, the

terms on which some individuals are permitted to make arrangements with

others. The common feature of these examples, as well as of licensure, is that

the legislation is enacted on behalf of a producer group. For licensure, the

producer group is generally a craft. For the other examples, it may be a group

producing a particular product which wants a tariff, a group of small retailers

who would like to be protected from competition by the "chiseling" chain stores,

or a group of oil producers, of farmers, or of steel workers.

Occupational licensure is by now very widespread. According to Walter

Gellhorn, who has written the best brief survey I know, "By 1952 more than 80

separate occupations exclusive of 'owner-businesses, 1 like restaurants and

taxicab companies, had been licensed by state law; and in addition to the state

laws there are municipal ordinances in abundance, not to mention the federal

statutes that require the licensing of such diverse occupations as radio operators

and stockyard commission agents. As long ago as 1938 a single state, North

Carolina, had extended its law to 60 occupations. One may not be surprised to

learn that pharmacists, accountants, and dentists have been reached by state

law as have sanitarians and psychologists, assayers and architects, veterinarians

and librarians. But with what joy of discovery does one learn about the licensing

of threshing machine operators and dealers in scrap tobacco? What of egg

graders and guide dog trainers, pest controllers and yacht salesmen, tree

surgeons and well diggers, tile layers and potato growers? And what of the

hypertrichologists who are licensed in Connecticut, where they remove excessive

and unsightly hair with the solemnity appropriate to their high sounding title?" 1

In the arguments that seek to persuade legislatures to enact such licensure

provisions, the justification is always said to be the necessity of protecting the

public interest. Flowever, the pressure on the legislature to license an occupation

rarely comes from the members of the public who have been mulcted or in other

ways abused by members of the occupation. On the contrary, the pressure

invariably comes from members of the occupation itself. Of course, they are

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more aware than others of how much they exploit the customer and so perhaps

they can lay claim to expert knowledge.

Similarly, the arrangements made for licensure almost invariably involve

control by members of the occupation which is to be licensed. Again, this is in

some ways quite natural. If the occupation of plumbing is to be restricted to

those who have the requisite capacity and skills to provide good service for their

customers, clearly only plumbers are capable of judging who should be licensed.

Consequently, the board or other body that grants licenses is almost invariably

made up largely of plumbers or pharmacists or physicians or whatever may be

the particular occupation licensed.

Gellhorn points out that "Seventy-five per cent of the occupational

licensing boards at work in this country today are composed exclusively of

licensed practitioners in the respective occupations. These men and women,

most of whom are only part-time officials, may have a direct economic interest in

many of the decisions they make concerning admission requirements and the

definition of standards to be observed by licensees. More importantly, they are

as a rule directly representative of organized groups within the occupations.

Ordinarily they are nominated by these groups as a step toward a gubernatorial

or other appointment that is frequently a mere formality. Often the formality is

dispensed with entirely, appointment being made directly by the occupational

association as happens, for example, with the embalmers in North Carolina, the

dentists in Alabama, the psychologists in Virginia, the physicians in Maryland,

and the attorneys in Washington." 2

Licensure therefore frequently establishes essentially the medieval guild

kind of regulation in which the state assigns power to the members of the

profession. In practice, the considerations taken into account in determining who

shall get a license often involve matters that, so far as a layman can see, have

no relation whatsoever to professional competence. This is not surprising. If a

few individuals are going to decide whether other individuals may pursue an

occupation, all sorts of irrelevant considerations are likely to enter. J ust what the

irrelevant considerations will be, will depend on the personalities of the members

of the licensing board and the mood of the time. Gellhorn notes the extent to

which a loyalty oath was required of various occupations when the fear of

communist subversion was sweeping the country. He writes, "A Texas statute of

1952 requires each applicant for a pharmacist's license to swear that 'he is not a

member of the Communist Party or affiliated with such party, and that he does

not believe in and is neither a member of nor supports any group or organization

that believes in, furthers or teaches the overthrow of the United States

Government by force or any illegal or unconstitutional methods.' The relationship

between this oath on the one hand and, on the other, the public health which is

the interest purportedly protected by the licensing of pharmacists, is somewhat

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obscure. No more apparent is the justification for requiring professional boxers

and wrestlers in I ndiana to swear that they are not subversive ... A junior high

school teacher of music, having been forced to resign after being identified as a

Communist, had difficulty becoming a piano tuner in the District of Columbia

because, forsooth, he was 'under Communist discipline.' Veterinarians in the

state of Washington may not minister to an ailing cow or cat unless they have

first signed a non-Communist oath." 3

Whatever one's attitude towards communism, any relationship between

the requirements imposed and the qualities which the licensure is intended to

assure is rather far-fetched. The extent to which such requirements go is

sometimes little short of ludicrous. A few more quotations from Gellhorn may

provide a touch of comic relief. 4

One of the most amusing sets of regulations is that laid down for barbers,

a trade that is licensed in many places. Here is an example from a law which was

declared invalid by Maryland courts, though similar language can be found in

statutes of other states which were declared legal. "The court was depressed

rather than impressed by a legislative command that neophyte barbers must

receive formal instruction in the 'scientific fundamentals for barbering, hygiene,

bacteriology, histology of the hair, skin, nails, muscles and nerves, structure of

the head, face and neck, elementary chemistry relating to sterilization and

antiseptics, disease of the skin, hair, glands and nails, haircutting, shaving and

arranging, dressing, coloring, bleaching, and tinting of the hair'. "5 One more

quotation on the barbers: "Of eighteen representative states included in a study

of barbering regulations in 1929, not one then commanded an aspirant to be a

graduate of a 'barber college,' though apprenticeship was necessary in all.

Today, the states typically insist upon graduation from a barbering school that

provides not less (and often much more) than one thousand hours of instruction

in 'theoretical subjects' such as sterilization of instruments, and this must still be

followed by apprenticeship." 6 I trust these quotations make it clear that the

problem of licensing of occupations is something more than a trivial illustration of

the problem of state intervention, that it is already in this country a serious

infringement on the freedom of individuals to pursue activities of their own

choice, and that it threatens to become a much more serious one with the

continual pressure upon legislatures to extend it.

Before discussing the advantages and disadvantages of licensing, it is

worth noting why we have it and what general political problem is revealed by

the tendency for such special legislation to be enacted. The declaration by a

large number of different state legislatures that barbers must be approved by a

committee of other barbers is hardly persuasive evidence that there is in fact a

public interest in having such legislation. Surely the explanation is different; it is

that a producer group tends to be more concentrated politically than a consumer

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group. This is an obvious point often made and yet one whose importance

cannot be overstressed. 7 Each of us is a producer and also a consumer.

However, we are much more specialized and devote a much larger fraction of

our attention to our activity as a producer than as a consumer. We consume

literally thousands if not millions of items. The result is that people in the same

trade, like barbers or physicians, all have an intense interest in the specific

problems of this trade and are willing to devote considerable energy to doing

something about them. On the other hand, those of us who use barbers at all,

get barbered infrequently and spend only a minor fraction of our income in

barber shops. Our interest is casual. Hardly any of us are willing to devote much

time going to the legislature in order to testify against the iniquity of restricting

the practice of barbering. The same point holds for tariffs. The groups that think

they have a special interest in particular tariffs are concentrated groups to whom

the issue makes a great deal of difference. The public interest is widely

dispersed. In consequence, in the absence of any general arrangements to offset

the pressure of special interests, producer groups will invariably have a much

stronger influence on legislative action and the powers that be than will the

diverse, widely spread consumer interest. Indeed from this point of view, the

puzzle is not why we have so many silly licensure laws, but why we don't have

far more. The puzzle is how we ever succeeded in getting the relative freedom

from government controls over the productive activities of individuals that we

have had and still have in this country, and that other countries have had as

well.

The only way that I can see to offset special producer groups is to

establish a general presumption against the state undertaking certain kinds of

activities. Only if there is a general recognition that governmental activities

should be severely limited with respect to a class of cases, can the burden of

proof be put strongly enough on those who would depart from this general

presumption to give a reasonable hope of limiting the spread of special measures

to further special interests. This point is one we have adverted to time and

again. It is of a piece with the argument for the Bill of Rights and for a rule to

govern monetary policy and fiscal policy.

Policy Issues Raised by Licensure

It is important to distinguish three different levels of control: first,

registration; second, certification; third, licensing.

By registration, I mean an arrangement under which individuals are

required to list their names in some official register if they engage in certain

kinds of activities. There is no provision for denying the right to engage in the

activity to anyone who is willing to list his name. He may be charged a fee, either

as a registration fee or as a scheme of taxation.

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The second level is certification. The governmental agency may certify

that an individual has certain skills but may not prevent, in any way, the practice

of any occupation using these skills by people who do not have such a

certificate. One example is accountancy. In most states, anybody can be an

accountant, whether he is a certified public accountant or not, but only those

people who have passed a particular test can put the title CPA after their names

or can put a sign in their offices saying they are certified public accountants.

Certification is frequently only an intermediate stage. In many states, there has

been a tendency to restrict an increasing range of activities to certified public

accountants. With respect to such activities there is licensure, not certification. In

some states, "architect" is a title which can be used only by those who have

passed a specified examination. This is certification. It does not prevent anyone

else from going into the business of advising people for a fee how to build

houses.

The third stage is licensing proper. This is an arrangement under which

one must obtain a license from a recognized authority in order to engage in the

occupation. The license is more than a formality. It requires some demonstration

of competence or the meeting of some tests ostensibly designed to insure

competence, and anyone who does not have a license is not authorized to

practice and is subject to a fine or a jail sentence if he does engage in practice.

The question I want to consider is this: under what circumstances, if any,

can we justify the one or the other of these steps? There are three different

grounds on which it seems to me registration can be justified consistently with

liberal principles.

First, it may assist in the pursuit of other aims. Let me illustrate. The

police are often concerned with acts of violence. After the event, it is desirable to

find out who had access to firearms. Before the event, it is desirable to prevent

firearms from getting into the hands of people who are likely to use them for

criminal purposes. It may assist in the pursuit of this aim to register stores selling

firearms. Of course, if I may revert to a point made several times in earlier

chapters, it is never enough to say that there might be a justification along these

lines, in order to conclude that there is justification. It is necessary to set up a

balance sheet of the advantages and disadvantages in the light of liberal

principles. All I am now saying is that this consideration might in some cases

justify overriding the general presumption against requiring the registration of

people.

Second, registration is sometimes a device to facilitate taxation and

nothing more. The questions at issue then become whether the particular tax is

an appropriate method to raise revenue for financing government services

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regarded as necessary, and whether registration facilitates the collection of

taxes. It may do so either because a tax is imposed on the person who registers,

or because the person who registers is used as a tax collector. For example, in

collecting a sales tax imposed on various items of consumption, it is necessary to

have a register or list of all the places selling goods subject to the tax.

Third, and this is the one possible justification for registration which is

close to our main interest, registration may be a means to protect consumers

against fraud. In general, liberal principles assign to the state the power to

enforce contracts, and fraud involves the violation of a contract. It is, of course,

dubious that one should go very far to protect in advance against fraud because

of the interference with voluntary contracts involved in doing so. But I do not

think that one can rule out on grounds of principle the possibility that there may

be certain activities that are so likely to give rise to fraud as to render it desirable

to have in advance a list of people known to be pursuing this activity. Perhaps

one example along these lines is the registration of taxicab drivers. A taxicab

driver picking up a person at night may be in a particularly good position to steal

from him. To inhibit such practices, it may be desirable to have a list of names of

people who are engaged in the taxicab business, to give each a number, and to

require that this number be put in the cab so that anyone molested need only

remember the number of the cab. This involves simply the use of the police

power to protect individuals against violence on the part of other individuals and

may be the most convenient method of doing so.

Certification is much more difficult to justify. The reason is that this is

something the private market generally can do for itself. This problem is the

same for products as for people's services. There are private certification

agencies in many areas that certify the competence of a person or the quality of

a particular product. The Good Housekeeping seal is a private certification

arrangement. For industrial products there are private testing laboratories that

will certify to the quality of a particular product. For consumer products, there

are consumer testing agencies of which Consumer's Union and Consumer's

Research are the best known in the United States. Better Business Bureaus are

voluntary organizations that certify the quality of particular dealers. Technical

schools, colleges, and universities certify the quality of their graduates. One

function of retailers and department stores is to certify the quality of the many

items they sell. The consumer develops confidence in the store, and the store in

turn has an incentive to earn this confidence by investigating the quality of the

items it sells.

One can however argue that in some cases, or perhaps even in many,

voluntary certification will not be carried as far as individuals would be willing to

pay for carrying it because of the difficulty of keeping the certification

confidential. The issue is essentially the one involved in patents and copyrights,

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namely, whether individuals are in a position to capture the value of the services

that they render to others. If I go into the business of certifying people, there

may be no efficient way in which I can require you to pay for my certification. If

I sell my certification information to one person, how can I keep him from

passing it on to others? Consequently, it may not be possible to get effective

voluntary exchange with respect to certification, even though this is a service

that people would be willing to pay for if they had to. One way to get around this

problem, as we get around other kinds of neighborhood effects, is to have

governmental certification.

Another possible justification for certification is on monopoly grounds.

There are some technical monopoly aspects to certification, since the cost of

making a certification is largely independent of the number of people to whom

the information is transmitted. However, it is by no means clear that monopoly is

inevitable.

Licensure seems to me still more difficult to justify. It goes still farther in

the direction of trenching upon the rights of individuals to enter into voluntary

contracts. Nonetheless, there are some justifications given for licensure that the

liberal will have to recognize as within his own conception of appropriate

government action, though, as always, the advantages have to be weighed

against the disadvantages. The main argument that is relevant to a liberal is the

existence of neighborhood effects. The simplest and most obvious example is the

"incompetent" physician who produces an epidemic. Insofar as he harms only his

patient, that is simply a question of voluntary contract and exchange between

the patient and his physician. On this score, there is no ground for intervention.

However, it can be argued that if the physician treats his patient badly, he may

unleash an epidemic that will cause harm to third parties who are not involved in

the immediate transaction. In such a case, it is conceivable that everybody,

including even the potential patient and physician, would be willing to submit to

the restriction of the practice of medicine to "competent" people in order to

prevent such epidemics from occurring.

In practice, the major argument given for licensure by its proponents is

not this one, which has some appeal to a liberal, but rather a strictly paternalistic

argument that has little or no appeal. Individuals, it is said, are incapable of

choosing their own servants adequately, their own physician or plumber or

barber. In order for a man to choose a physician intelligently, he would have to

be a physician himself. Most of us, it is said, are therefore incompetent and we

must be protected against our own ignorance. This amounts to saying that we in

our capacity as voters must protect ourselves in our capacity as consumers

against our own ignorance, by seeing to it that people are not served by

incompetent physicians or plumbers or barbers.

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So far, I have been listing the arguments for registration, certification, and

licensing. In all three cases, it is clear that there are also strong social costs to be

set against any of these advantages. Some of these social costs have already

been suggested and I shall illustrate them in more detail for medicine, but it may

be worth recording them here in general form.

The most obvious social cost is that any one of these measures, whether

it be registration, certification, or licensure, almost inevitably becomes a tool in

the hands of a special producer group to obtain a monopoly position at the

expense of the rest of the public. There is no way to avoid this result. One can

devise one or another set of procedural controls designed to avert this outcome,

but none is likely to overcome the problem that arises out of the greater

concentration of producer than of consumer interest. The people who are most

concerned with any such arrangement, who will press most for its enforcement

and be most concerned with its administration, will be the people in the

particular occupation or trade involved. They will inevitably press for the

extension of registration to certification and of certification to licensure. Once

licensure is attained, the people who might develop an interest in undermining

the regulations are kept from exerting their influence. They don't get a license,

must therefore go into other occupations, and will lose interest. The result is

invariably control over entry by members of the occupation itself and hence the

establishment of a monopoly position.

Certification is much less harmful in this respect. If the certified "abuse"

their special certificates; if, in certifying newcomers, members of the trade

impose unnecessarily stringent requirements and reduce the number of

practitioners too much, the price differential between certified and non-certified

will become sufficiently large to induce the public to use non-certified

practitioners. In technical terms, the elasticity of demand for the services of

certified practitioners will be fairly large, and the limits within which they can

exploit the rest of the public by taking advantage of their special position will be

rather narrow.

In consequence, certification without licensure is a half-way house that

maintains a good deal of protection against monopolization. It also has its

disadvantages, but it is worth noting that the usual arguments for licensure, and

in particular the paternalistic arguments, are satisfied almost entirely by

certification alone. If the argument is that we are too ignorant to judge good

practitioners, all that is needed is to make the relevant information available. If,

in full knowledge, we still want to go to someone who is not certified, that is our

business; we cannot complain that we did not have the information. Since

arguments for licensure made by people who are not members of the occupation

can be satisfied so fully by certification, I personally find it difficult to see any

case for which licensure rather than certification can be justified.

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Even registration has significant social costs. It is an important first step in

the direction of a system in which every individual has to carry an identity card,

every individual has to inform authorities what he plans to do before he does it.

Moreover, as already noted, registration tends to be the first step toward

certification and licensure.

Medical Licensure

The medical profession is one in which practice of the profession has for a

long time been restricted to people with licenses. Offhand, the question, "Ought

we to let incompetent physicians practice?" seems to admit of only a negative

answer. But I want to urge that second thought may give pause.

In the first place, licensure is the key to the control that the medical

profession can exercise over the number of physicians. To understand why this is

so requires some discussion of the structure of the medical profession. The

American Medical Association is perhaps the strongest trade union in the United

States. The essence of the power of a trade union is its power to restrict the

number who may engage in a particular occupation. This restriction may be

exercised indirectly by being able to enforce a wage rate higher than would

otherwise prevail. If such a wage rate can be enforced, it will reduce the number

of people who can get jobs and thus indirectly the number of people pursuing

the occupation. This technique of restriction has disadvantages. There is always

a dissatisfied fringe of people who are trying to get into the occupation. A trade

union is much better off if it can limit directly the number of people who enter

the occupation who ever try to get jobs in it. The disgruntled and dissatisfied are

excluded at the outset, and the union does not have to worry about them.

The American Medical Association is in this position. It is a trade union

that can limit the number of people who can enter. How can it do this? The

essential control is at the stage of admission to medical school. The Council on

Medical Education and Hospitals of the American Medical Association approves

medical schools. In order for a medical school to get and stay on its list of

approved schools it has to meet the standards of the Council. The power of the

Council has been demonstrated at various times when there has been pressure

to reduce numbers. For example, in the 1930's during the depression, the

Council on Medical Education and Hospitals wrote a letter to the various medical

schools saying the medical schools were admitting more students than could be

given the proper kind of training. In the next year or two, every school reduced

the number it was admitting, giving very strong presumptive evidence that the

recommendation had some effect.

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Why does the Council's approval matter so much? If it abuses its power,

why don't unapproved medical schools arise? The answer is that in almost every

state in the United States, a person must be licensed to practice medicine, and to

get the license, he must be a graduate of an approved school. In almost every

state, the list of approved schools is identical with the list of schools approved by

the Council on Medical Education and Hospitals of the American Medical

Association. That is why the licensure provision is the key to the effective control

of admission. It has a dual effect. On the one hand, the members of the

licensure commission are always physicians and hence have some control at the

step at which men apply for a license. This control is more limited in

effectiveness than control at the medical school level. In almost all professions

requiring licensure, people may try to get admitted more than once. If a person

tries long enough and in enough jurisdictions he is likely to get through sooner or

later. Since he has already spent the money and time to get his training, he has

a strong incentive to keep trying. Licensure provisions that come into operation

only after a man is trained therefore affect entry largely by raising the costs of

getting into the occupation, since it may take a longer time to get in and since

there is always some uncertainty whether he will succeed. But this rise in cost is

nothing like so effective in limiting entry as is preventing a man from getting

started on his career. If he is eliminated at the stage of entering medical school,

he never comes up as a candidate for examination; he can never be troublesome

at that stage. The efficient way to get control over the number in a profession is

therefore to get control of entry into professional schools.

Control over admission to medical school and later licensure enables the

profession to limit entry in two ways. The obvious one is simply by turning down

many applicants. The less obvious, but probably far more important one, is by

establishing standards for admission and licensure that make entry so difficult as

to discourage young people from ever trying to get admission. Though most

state laws require only two years of college prior to medical school, nearly 100

per cent of the entrants have had four years of college. Similarly, medical

training proper has been lengthened, particularly through more stringent

internship arrangements.

As an aside, the lawyers have never been as successful as the physicians

in getting control at the point of admission to professional school, though they

are moving in that direction. The reason is amusing. Almost every school on the

American Bar Association's list of approved schools is a full time day school;

almost no night schools are approved. Many state legislators, on the other hand,

are graduates of night law schools. If they voted to restrict admission to the

profession to graduates of approved schools, in effect they would be voting that

they themselves were not qualified. Their reluctance to condemn their own

competence has been the main factor that has tended to limit the extent to

which law has been able to succeed in imitating medicine. I have not myself

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done any extensive work on requirements for admission to law for many years

but I understand that this limitation is breaking down. The greater affluence of

students means that a much larger fraction are going to full time law schools and

this is changing the composition of the legislatures.

To return to medicine, it is the provision about graduation from approved

schools that is the most important source of professional control over entry. The

profession has used this control to limit numbers. To avoid misunderstanding let

me emphasize that I am not saying that individual members of the medical

profession, the leaders of the medical profession, or the people who are in

charge of the Council on Medical Education and Hospitals deliberately go out of

their way to limit entry in order to raise their own incomes. That is not the way it

works. Even when such people explicitly comment on the desirability of limiting

numbers to raise incomes they will always justify the policy on the grounds that

if "too" many people are let in, this will lower their incomes so that they will be

driven to resort to unethical practices in order to earn a "proper" income. The

only way, they argue, in which ethical practices can be maintained is by keeping

people at a standard of income which is adequate to the merits and needs of the

medical profession. I must confess that this has always seemed to me

objectionable on both ethical and factual grounds. It is extraordinary that leaders

of medicine should proclaim publicly that they and their colleagues must be paid

to be ethical. And if it were so, I doubt that the price would have any limit. There

seems little correlation between poverty and honesty. One would rather expect

the opposite; dishonesty may not always pay but surely it sometimes does.

Control of entry is explicitly rationalized along these lines only at times like

the Great Depression when there is much unemployment and relatively low

incomes. In ordinary times, the rationalization for restriction is different. It is that

the members of the medical profession want to raise what they regard as the

standards of "quality" of the profession. The defect in this rationalization is a

common one, and one that is destructive of a proper understanding of the

operation of an economic system, namely, the failure to distinguish between

technical efficiency and economic efficiency.

A story about lawyers will perhaps illustrate the point. At a meeting of

lawyers at which problems of admission were being discussed, a colleague of

mine, arguing against restrictive admission standards, used an analogy from the

automobile industry. Would it not, he said, be absurd if the automobile industry

were to argue that no one should drive a low quality car and therefore that no

automobile manufacturer should be permitted to produce a car that did not come

up to the Cadillac standard. One member of the audience rose and approved the

analogy, saying that, of course, the country cannot afford anything but Cadillac

lawyers! This tends to be the professional attitude. The members look solely at

technical standards of performance, and argue in effect that we must have only

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firstrate physicians even if this means that some people get no medical service

though of course they never put it that way. Nonetheless, the view that people

should get only the "optimum" medical service always lead to a restrictive policy,

a policy that keeps down the number of physicians. I would not, of course, want

to argue that this is the only force at work, but only that this kind of

consideration leads many well-meaning physicians to go along with policies that

they would reject out-of-hand if they did not have this kind of comforting

rationalization.

It is easy to demonstrate that quality is only a rationalization and not the

underlying reason for restriction. The power of the Council on Medical Education

and Hospitals of the American Medical Association has been used to limit

numbers in ways that cannot possibly have any connection whatsoever with

quality. The simplest example is their recommendation to various states that

citizenship be made a requirement for the practice of medicine. I find it

inconceivable to see how this is relevant to medical performance. A similar

requirement that they have tried to impose on occasion is that examination for

licensure must be taken in English. A dramatic piece of evidence on the power

and potency of the Association as well as on the lack of relation to quality is

proved by one figure that I have always found striking. After 1933, when Hitler

came to power in Germany, there was a tremendous outflow of professional

people from Germany, Austria and so on, including of course, physicians who

wanted to practice in the United States. The number of physicians trained abroad

who were admitted to practice in the United States in the five years after 1933

was the same as in the five years before. This was clearly not the result of the

natural course of events. The threat of these additional physicians led to a

stringent tightening of requirements for foreign physicians that imposed extreme

costs upon them.

It is clear that licensure is the key to the medical profession's ability to

restrict the number of physicians who practice medicine. It is also the key to its

ability to restrict technological and organizational changes in the way medicine is

conducted. The American Medical Association has been consistently against the

practice of group medicine, and against prepaid medical plans. These methods of

practice may have good features and bad features, but they are technological

innovations that people ought to be free to try out if they wish. There is no basis

for saying conclusively that the optimum technical method of organizing medical

practice is practice by an independent physician. Maybe it is group practice,

maybe it is by corporations. One ought to have a system under which all

varieties can be tried.

The American Medical Association has resisted such attempts and has

been able effectively to inhibit them. It has been able to do so because licensure

has indirectly given it control of admission to practice in hospitals. The Council on

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Medical Education and Hospitals approves hospitals as well as medical schools.

In order for a physician to get admission to practice in an "approved" hospital,

he must generally be approved by his county medical association or by the

hospital board. Why can't unapproved hospitals be set up? Because under

present economic conditions, in order for a hospital to operate it must have a

supply of interns. Under most state licensure laws, candidates must have some

internship experience to be admitted to practice, and internship must be in an

"approved" hospital. The list of "approved" hospitals is generally identical with

that of the Council on Medical Education and Hospitals. Consequently, the

licensure law gives the profession control over hospitals as well as over schools.

This is the key to the AMA's largely successful opposition to various types of

group practice. In a few cases, the groups have been able to survive. In the

District of Columbia, they succeeded because they were able to bring suit against

the American Medical Association under the federal Sherman antitrust laws, and

won the suit. In a few other cases, they have succeeded for special reasons.

There is, however, no doubt that the tendency toward group practice has been

greatly retarded by the AMA's opposition.

It is interesting, and this is an aside, that the medical association is

against only one type of group practice, namely, prepaid group practice. The

economic reason seems to be that this eliminates the possibility of engaging in

discriminatory pricing . 8

It is clear that licensure has been at the core of the restriction of entry

and that this involves a heavy social cost, both to the individuals who want to

practice medicine but are prevented from doing so and to the public deprived of

the medical care it wants to buy and is prevented from buying. Let me now ask

the question: Does licensure have the good effects that it is said to have?

In the first place, does it really raise standards of competence? It is by no

means clear that it does raise the standards of competence in the actual practice

of the profession for several reasons. In the first place, whenever you establish a

block to entry into any field, you establish an incentive to find ways of getting

around it, and of course medicine is no exception. The rise of the professions of

osteopathy and of chiropractic is not unrelated to the restriction of entry into

medicine. On the contrary, each of these represented, to some extent, an

attempt to find a way around restriction of entry. Each of these, in turn, is

proceeding to get itself licensed, and to impose restrictions. The effect is to

create different levels and kinds of practice, to distinguish between what is called

medical practice and substitutes such as osteopathy, chiropractic, faith healing

and so on. These alternatives may well be of lower quality than medical practice

would have been without the restrictions on entry into medicine.

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More generally, if the number of physicians is less than it otherwise would

be, and if they are all fully occupied, as they generally are, this means that there

is a smaller total of medical practice by trained physicians fewer medical man-

hours of practice, as it were. The alternative is untrained practice by somebody;

it may and in part must be by people who have no professional qualifications at

all. Moreover, the situation is much more extreme. If "medical practice" is to be

limited to licensed practitioners, it is necessary to define what medical practice is,

and featherbedding is not something that is restricted to the railroads. Under the

interpretation of the statutes forbidding unauthorized practice of medicine, many

things are restricted to licensed physicians that could perfectly well be done by

technicians, and other skilled people who do not have a Cadillac medical training.

I am not enough of a technician to list the examples at all fully. I only know that

those who have looked into the question say that the tendency is to include in

"medical practice" a wider and wider range of activities that could perfectly well

be performed by technicians. Trained physicians devote a considerable part of

their time to things that might well be done by others. The result is to reduce

drastically the amount of medical care. The relevant average quality of medical

care, if one can at all conceive of the concept, cannot be obtained by simply

averaging the quality of care that is given; that would be like judging the

effectiveness of a medical treatment by considering only the survivors; one must

also allow for the fact that the restrictions reduce the amount of care. The result

may well be that the average level of competence in a meaningful sense has

been reduced by the restrictions.

Even these comments do not go far enough, because they consider the

situation at a point in time and do not allow for changes over time. Advances in

any science or field often result from the work of one out of a large number of

crackpots and quacks and people who have no standing in the profession. In the

medical profession, under present circumstances, it is very difficult to engage in

research or experimentation unless you are a member of the profession. If you

are a member of the profession and want to stay in good standing in the

profession, you are seriously limited in the kind of experimentation you can do. A

"faith healer" may be just a quack who is imposing himself on credulous patients,

but maybe one in a thousand or in many thousands will produce an important

improvement in medicine. There are many different routes to knowledge and

learning and the effect of restricting the practice of what is called medicine and

defining it as we tend to do to a particular group, who in the main have to

conform to the prevailing orthodoxy, is certain to reduce the amount of

experimentation that goes on and hence to reduce the rate of growth of

knowledge in the area. What is true for the content of medicine is true also for

its organization, as has already been suggested. I shall expand further on this

point below.

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There is still another way in which licensure, and the associated monopoly

in the practice of medicine, tend to render standards of practice low. I have

already suggested that it renders the average quality of practice low by reducing

the number of physicians, by reducing the aggregate number of hours available

from trained physicians for more rather than less important tasks, and by

reducing the incentive for research and development. It renders it low also by

making it much more difficult for private individuals to collect from physicians for

malpractice. One of the protections of the individual citizen against incompetence

is protection against fraud and the ability to bring suit in the court against

malpractice. Some suits are brought, and physicians complain a great deal about

how much they have to pay for malpractice insurance. Yet suits for malpractice

are fewer and less successful than they would be were it not for the watchful eye

of the medical associations. It is not easy to get a physician to testify against a

fellow physician when he faces the sanction of being denied the right to practice

in an "approved" hospital. The testimony generally has to come from members

of panels set up by medical associations themselves, always, of course, in the

alleged interest of the patients.

When these effects are taken into account, I am myself persuaded that

licensure has reduced both the quantity and quality of medical practice; that it

has reduced the opportunities available to people who would like to be

physicians, forcing them to pursue occupations they regard as less attractive;

that it has forced the public to pay more for less satisfactory medical service, and

that it has retarded technological development both in medicine itself and in the

organization of medical practice. I conclude that licensure should be eliminated

as a requirement for the practice of medicine.

When all this is said, many a reader, I suspect, like many a person with

whom I have discussed these issues, will say, "But still, how else would I get any

evidence on the quality of a physician. Granted all that you say about costs, is

not licensure the only way of providing the public with some assurance of at

least minimum quality ?" The answer is partly that people do not now choose

physicians by picking names at random from a list of licensed physicians; partly,

that a man's ability to pass an examination twenty or thirty years earlier is hardly

assurance of quality now; hence, licensure is not now the main or even a major

source of assurance of at least minimum quality. But the major answer is very

different. It is that the question itself reveals the tyranny of the status quo and

the poverty of our imagination in fields in which we are laymen, and even in

those in which we have some competence, by comparison with the fertility of the

market. Let me illustrate by speculating on how medicine might have developed

and what assurances of quality would have emerged, if the profession had not

exerted monopoly power.

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Suppose that anyone had been free to practice medicine without

restriction except for legal and financial responsibility for any harm done to

others through fraud and negligence. I conjecture that the whole development of

medicine would have been different. The present market for medical care,

hampered as it has been, gives some hints of what the difference would have

been. Group practice in conjunction with hospitals would have grown

enormously. Instead of individual practice plus large institutional hospitals

conducted by governments or eleemosynary institutions, there might have

developed medical partnerships or corporations medical teams. These would

have provided central diagnostic and treatment facilities, including hospital

facilities. Some presumably would have been prepaid, combining in one package

present hospital insurance, health insurance, and group medical practice. Others

would have charged separate fees for separate services. And of course, most

might have used both methods of payment.

These medical teams department stores of medicine, if you will would be

intermediaries between the patients and the physician. Being long-lived and

immobile, they would have a great interest in establishing a reputation for

reliability and quality. For the same reason, consumers would get to know their

reputation. They would have the specialized skill to judge the quality of

physicians; indeed, they would be the agent of the consumer in doing so, as the

department store is now for many a product. In addition, they could organize

medical care efficiently, combining medical men of different degrees of skill and

training, using technicians with limited training for tasks for which they were

suited, and reserving highly skilled and competent specialists for the tasks they

alone could perform. The reader can add further flourishes for himself, drawing

in part, as I have done, on what now goes on at the leading medical clinics.

Of course, not all medical practice would be done through such teams.

Individual private practice would continue, just as the small store with a limited

clientele exists alongside the department store, the individual lawyer alongside

the great many-partnered firm. Men would establish individual reputations and

some patients would prefer the privacy and intimacy of the individual

practitioner. Some areas would be too small to be served by medical teams. And

so on.

I would not even want to maintain that the medical teams would

dominate the field. My aim is only to show by example that there are many

alternatives to the present organization of practice. The impossibility of any

individual or small group conceiving of all the possibilities, let alone evaluating

their merits, is the great argument against central governmental planning and

against arrangements such as professional monopolies that limit the possibilities

of experimentation. On the other side, the great argument for the market is its

tolerance of diversity; its ability to utilize a wide range of special knowledge and

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capacity. It renders special groups impotent to prevent experimentation and

permits the customers and not the producers to decide what will serve the

customers best.

1 Walter Gellhorn, Individual Freedom and Governmental Restraints (Baton

Rouge: Louisiana State University Press, 1956). Chapter entitled "The Right to

Make a Living," p. 106.

2 Ibid. pp. 14041.

3 Ibid., pp. 12930.

4 In fairness to Walter Gellhorn, I should note that he does not share my view

that the correct solution to these problems is to abandon licensing. On the

contrary, he thinks that while licensing has gone much too far it has some real

functions to perform. He suggests procedural reforms and changes that in his

view would limit the abuse of licensure arrangements.

5 Ibid., pp. 12122.

6 Ibid., p. 146.

7 See, for example, Wesley Mitchell's famous article on the "Backward Art of

Spending Money," reprinted in his book of essays carrying that title (New York:

McGraw-Hill, 1937), pp. 319.

8 See Reuben Kessel, "Price Discrimination in Medicine," The Journal of Law and

Economics, Vol. I (October, 1958), 2053.

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Chapter X

The Distribution of I ncome

A central element in the development of a collectivist sentiment in this

century, at least in Western countries, has been a belief in equality of income as

a social goal and a willingness to use the arm of the state to promote it. Two

very different questions must be asked in evaluating this egalitarian sentiment

and the egalitarian measures it has produced. The first is normative and ethical:

what is the justification for state intervention to promote equality? The second is

positive and scientific: what has been the effect of the measures actually taken?

The Ethics of Distribution

The ethical principle that would directly justify the distribution of income

in a free market society is, "To each according to what he and the instruments

he owns produces." The operation of even this principle implicitly depends on

state action. Property rights are matters of law and social convention. As we

have seen, their definition and enforcement is one of the primary functions of

the state. The final distribution of income and wealth under the full operation of

this principle may well depend markedly on the rules of property adopted.

What is the relation between this principle and another that seems

ethically appealing, namely, equality of treatment? In part, the two principles are

not contradictory. Payment in accordance with product may be necessary to

achieve true equality of treatment. Given individuals whom we are prepared to

regard as alike in ability and initial resources, if some have a greater taste for

leisure and others for marketable goods, inequality of return through the market

is necessary to achieve equality of total return or equality of treatment. One man

may prefer a routine job with much time off for basking in the sun to a more

exacting job paying a higher salary; another man may prefer the opposite. If

both were paid equally in money, their incomes in a more fundamental sense

would be unequal. Similarly, equal treatment requires that an individual be paid

more for a dirty, unattractive job than for a pleasant rewarding one. Much

observed inequality is of this kind. Differences of money income offset

differences in other characteristics of the occupation or trade. In the jargon of

economists, they are "equalizing differences" required to make the whole of the

"net advantages," pecuniary and non-pecuniary, the same.

Another kind of inequality arising through the operation of the market is

also required, in a somewhat more subtle sense, to produce equality of

treatment, or to put it differently to satisfy men's tastes. It can be illustrated

most simply by a lottery. Consider a group of individuals who initially have equal

endowments and who all agree voluntarily to enter a lottery with very unequal

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prizes. The resultant inequality of income is surely required to permit the

individuals in question to make the most of their initial equality. Redistribution of

the income after the event is equivalent to denying them the opportunity to

enter the lottery. This case is far more important in practice than would appear

by taking the notion of a "lottery" literally. Individuals choose occupations,

investments, and the like partly in accordance with their taste for uncertainty.

The girl who tries to become a movie actress rather than a civil servant is

deliberately choosing to enter a lottery, so is the individual who invests in penny

uranium stocks rather than government bonds. Insurance is a way of expressing

a taste for certainty. Even these examples do not indicate fully the extent to

which actual inequality may be the result of arrangements designed to satisfy

men's tastes. The very arrangements for paying and hiring people are affected

by such preferences. If all potential movie actresses had a great dislike of

uncertainty, there would tend to develop "co-operatives" of movie actresses, the

members of which agreed in advance to share income receipts more or less

evenly, thereby in effect providing themselves insurance through the pooling of

risks. If such a preference were widespread, large diversified corporations

combining risky and non-risky ventures would become the rule. The wild-cat oil

prospector, the private proprietorship, the small partnership, would all become

rare.

Indeed, this is one way to interpret governmental measures to redistribute

income through progressive taxes and the like. It can be argued that for one

reason or another, costs of administration perhaps, the market cannot produce

the range of lotteries or the kind of lottery desired by the members of the

community, and that progressive taxation is, as it were, a government enterprise

to do so. I have no doubt that this view contains an element of truth. At the

same time, it can hardly justify present taxation, if only because the taxes are

imposed after it is already largely known who have drawn the prizes and who the

blanks in the lottery of life, and the taxes are voted mostly by those who think

they have drawn the blanks. One might, along these lines, justify one

generation's voting the tax schedules to be applied to an as yet unborn

generation. Any such procedure would, I conjecture, yield income tax schedules

much less highly graduated than present schedules are, at least on paper.

Though much of the inequality of income produced by payment in

accordance with product reflects "equalizing" differences or the satisfaction of

men's tastes for uncertainty, a large part reflects initial differences in

endowment, both of human capacities and of property. This is the part that

raises the really difficult ethical issue.

It is widely argued that it is essential to distinguish between inequality in

personal endowments and in property, and between inequalities arising from

inherited wealth and from acquired wealth. Inequality resulting from differences

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in personal capacities, or from differences in wealth accumulated by the

individual in question, are considered appropriate, or at least not so clearly

inappropriate as differences resulting from inherited wealth.

This distinction is untenable. Is there any greater ethical justification for

the high returns to the individual who inherits from his parents a peculiar voice

for which there is a great demand than for the high returns to the individual who

inherits property? The sons of Russian commissars surely have a higher

expectation of income perhaps also of liquidation than the sons of peasants. Is

this any more or less justifiable than the higher income expectation of the son of

an American millionaire? We can look at this same question in another way. A

parent who has wealth that he wishes to pass on to his child can do so in

different ways. He can use a given sum of money to finance his child's training

as, say, a certified public accountant, or to set him up in business, or to set up a

trust fund yielding him a property income. In any of these cases, the child will

have a higher income than he otherwise would. But in the first case, his income

will be regarded as coming from human capacities; in the second, from profits;

in the third, from inherited wealth. Is there any basis for distinguishing among

these categories of receipts on ethical grounds? Finally, it seems illogical to say

that a man is entitled to what he has produced by personal capacities or to the

produce of the wealth he has accumulated, but that he is not entitled to pass

any wealth on to his children; to say that a man may use his income for riotous

living but may not give it to his heirs. Surely, the latter is one way to use what

he has produced.

The fact that these arguments against the so-called capitalist ethic are

invalid docs not of course demonstrate that the capitalist ethic is an acceptable

one. I find it difficult to justify either accepting or rejecting it, or to justify any

alternative principle.

I am led to the view that it cannot in and of itself be regarded as an

ethical principle; that it must be regarded as instrumental or a corollary of some

other principle such as freedom.

Some hypothetical examples may illustrate the fundamental difficulty.

Suppose there are four Robinson Crusoes, independently marooned on four

islands in the same neighborhood. One happened to land on a large and fruitful

island which enables him to live easily and well. The others happened to land on

tiny and rather barren islands from which they can barely scratch a living. One

day, they discover the existence of one another. Of course, it would be generous

of the Crusoe on the large island if he invited the others to join him and share its

wealth. But suppose he does not. Would the other three be justified in joining

forces and compelling him to share his wealth with them? Many a reader will be

tempted to say yes. But before yielding to this temptation, consider precisely the

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same situation in different guise. Suppose you and three friends are walking

along the street and you happen to spy and retrieve a $ 20 bill on the pavement.

It would be generous of you, of course, if you were to divide it equally with

them, or at least blow them to a drink. But suppose you do not. Would the other

three be justified in joining forces and compelling you to share the $ 20 equally

with them? I suspect most readers will be tempted to say no. And on further

reflection, they may even conclude that the generous course of action is not

itself clearly the "right" one. Are we prepared to urge on ourselves or our fellows

that any person whose wealth exceeds the average of all persons in the world

should immediately dispose of the excess by distributing it equally to all the rest

of the world's inhabitants ? We may admire and praise such action when

undertaken by a few. But a universal "potlatch" would make a civilized world

impossible.

In any event, two wrongs do not make a right. The unwillingness of the

rich Robinson Crusoe or the lucky finder of the $ 20 bill to share his wealth does

not justify the use of coercion by the others. Can we justify being judges in our

own case, deciding on our own when we are entitled to use force to extract what

we regard as our due from others? Or what we regard as not their due? Most

differences of status or position or wealth can be regarded as the product of

chance at a far enough remove. The man who is hard working and thrifty is to

be regarded as "deserving"; yet these qualities owe much to the genes he was

fortunate (or unfortunate?) enough to inherit.

Despite the lip service that we all pay to "merit" as compared to "chance,"

we are generally much readier to accept inequalities arising from chance than

those clearly attributable to merit. The college professor whose colleague wins a

sweepstake will envy him but is unlikely to bear him any malice or to feel

unjustly treated. Let the colleague receive a trivial raise that makes his salary

higher than the professor's own, and the professor is far more likely to feel

aggrieved. After all, the goddess of chance, as of justice, is blind. The salary

raise was a deliberate judgment of relative merit.

The Instrumental Role of Distribution According to Product

The operative function of payment in accordance with product in a market

society is not primarily distributive, but allocative. As was pointed out in chapter

i, the central principle of a market economy is co-operation through voluntary

exchange. Individuals co-operate with others because they can in this way

satisfy their own wants more effectively. But unless an individual receives the

whole of what he adds to the product, he will enter into exchanges on the basis

of what he can receive rather than what he can produce. Exchanges will not take

place that would have been mutually beneficial if each party received what he

contributed to the aggregate product. Payment in accordance with product is

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therefore necessary in order that resources be used most effectively, at least

under a system depending on voluntary co-operation. Given sufficient

knowledge, it might be that compulsion could be substituted for the incentive of

reward, though I doubt that it could. One can shuffle inanimate objects around;

one can compel individuals to be at certain places at certain times; but one can

hardly compel individuals to put forward their best efforts. Put another way, the

substitution of compulsion for co-operation changes the amount of resources

available.

Though the essential function of payment in accordance with product in a

market society is to enable resources to be allocated efficiently without

compulsion, it is unlikely to be tolerated unless it is also regarded as yielding

distributive justice. No society can be stable unless there is a basic core of value

judgments that are unthinkingly accepted by the great bulk of its members.

Some key institutions must be accepted as "absolutes," not simply as

instrumental. I believe that payment in accordance with product has been, and,

in large measure, still is, one of these accepted value judgments or institutions.

One can demonstrate this by examining the grounds on which the internal

opponents of the capitalist system have attacked the distribution of income

resulting from it. It is a distinguishing feature of the core of central values of a

society that it is accepted alike by its members, whether they regard themselves

as proponents or as opponents of the system of organization of the society. Even

the severest internal critics of capitalism have implicitly accepted payment in

accordance with product as ethically fair.

The most far-reaching criticism has come from the Marxists. Marx argued

that labor was exploited. Why? Because labor produced the whole of the product

but got only part of it; the rest is Marx's "surplus value." Even if the statements

of fact implicit in this assertion were accepted, the value judgment follows only if

one accepts the capitalist ethic. Labor is "exploited" only if labor is entitled to

what it produces. If one accepts instead the socialist premise, "to each according

to his need, from each according to his ability" whatever that may mean it is

necessary to compare what labor produces, not with what it gets but with its

"ability", and to compare what labor gets, not with what it produces but with its

"need."

Of course, the Marxist argument is invalid on other grounds as well. There

is, first, the confusion between the total product of all co-operating resources

and the amount added to productin the economist's jargon, marginal product.

Even more striking, there is an unstated change in the meaning of "labor" in

passing from the premise to the conclusion. Marx recognized the role of capital in

producing the product but regarded capital as embodied labor. Hence, written

out in full, the premises of the Marxist syllogism would run: "Present and past

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labor produce the whole of the product. Present labor gets only part of the

product." The logical conclusion is presumably "Past labor is exploited," and the

inference for action is that past labor should get more of the product, though it is

by no means clear how, unless it be in elegant tombstones.

The achievement of allocation of resources without compulsion is the

major instrumental role in the market place of distribution in accordance with

product. But it is not the only instrumental role of the resulting inequality. We

have noted in chapter i the role that inequality plays in providing independent

foci of power to offset the centralization of political power, as well as the role

that it plays in promoting civil freedom by providing "patrons" to finance the

dissemination of unpopular or simply novel ideas. In addition, in the economic

sphere, it provides "patrons" to finance experimentation and the development of

new products to buy the first experimental automobiles and television sets, let

alone impressionist paintings. Finally, it enables distribution to occur impersonally

without the need for "authority" a special facet of the general role of the market

in effecting co-operation and co-ordination without coercion.

Facts of Income Distribution

A capitalist system involving payment in accordance with product can be,

and in practice is, characterized by considerable inequality of income and wealth.

This fact is frequently misinterpreted to mean that capitalism and free enterprise

produce wider inequality than alternative systems and, as a corollary, that the

extension and development of capitalism has meant increased inequality. This

misinterpretation is fostered by the misleading character of most published

figures on the distribution of income, in particular their failure to distinguish

shortrun from long-run inequality. Let us look at some of the broader facts about

the distribution of income.

One of the most striking facts which runs counter to many people's

expectation has to do with the sources of income. The more capitalistic a country

is, the smaller the fraction of income paid for the use of what is generally

regarded as capital, and the larger the fraction paid for human services. In

underdeveloped countries like India, Egypt, and so on, something like half of

total income is property income. In the United States, roughly one-fifth is

property income. And in other advanced capitalist countries, the proportion is not

very different. Of course, these countries have much more capital than the

primitive countries but they are even richer in the productive capacity of their

residents; hence, the larger income from property is a smaller fraction of the

total. The great achievement of capitalism has not been the accumulation of

property, it has been the opportunities it has offered to men and women to

extend and develop and improve their capacities. Yet the enemies of capitalism

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are fond of castigating it as materialist, and its friends all too often apologize for

capitalism's materialism as a necessary cost of progress.

Another striking fact, contrary to popular conception, is that capitalism

leads to less inequality than alternative systems of organization and that the

development of capitalism has greatly lessened the extent of inequality.

Comparisons over space and time alike confirm this view. There is surely

drastically less inequality in Western capitalist societies like the Scandinavian

countries, France, Britain, and the United States, than in a status society like

India or a backward country like Egypt. Comparison with communist countries

like Russia is more difficult because of paucity and unreliability of evidence. But if

inequality is measured by differences in levels of living between the privileged

and other classes, such inequality may well be decidedly less in capitalist than in

communist countries. Among the Western countries alone, inequality appears to

be less, in any meaningful sense, the more highly capitalist the country is: less in

Britain than in France, less in the United States than in Britain though these

comparisons are rendered difficult by the problem of allowing for the intrinsic

heterogeneity of populations; for a fair comparison, for example, one should

perhaps compare the United States, not with the United Kingdom alone but with

the United Kingdom plus the West Indies plus its African possessions.

With respect to changes over time, the economic progress achieved in the

capitalist societies has been accompanied by a drastic diminution in inequality. As

late as 1848, John Stuart Mill could write, "Hitherto [1848] it is questionable if all

the mechanical inventions yet made have lightened the day's toil of any human

being. They have enabled a greater population to live the same life of drudgery

and imprisonment, and an increased number of manufacturers and others to

make fortunes. They have increased the comforts of the middle classes. But they

have not yet begun to effect those great changes in human destiny, which it is in

their nature and in their futurity to accomplish." 1 This statement was probably

not correct even for Mill's day, but certainly no one could write this today about

the advanced capitalist countries. It is still true about the rest of the world.

The chief characteristic of progress and development over the past

century is that it has freed the masses from backbreaking toil and has made

available to them products and services that were formerly the monopoly of the

upper classes, without in any corresponding way expanding the products and

services available to the wealthy. Medicine aside, the advances in technology

have for the most part simply made available to the masses of the people

luxuries that were always available in one form or another to the truly wealthy.

Modern plumbing, central heating, automobiles, television, radio, to cite just a

few examples, provide conveniences to the masses equivalent to those that the

wealthy could always get by the use of servants, entertainers, and so on.

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Detailed statistical evidence on these phenomena, in the form of

meaningful and comparable distributions of income, is hard to come by, though

such studies as have been made confirm the broad conclusions just outlined.

Such statistical data, however, can be extremely misleading. They cannot

segregate differences in income that are equalizing from those that are not. For

example, the short working life of a baseball player means that the annual

income during his active years must be much higher than in alternative pursuits

open to him to make it equally attractive financially. But such a difference affects

the figures in exactly the same way as any other difference in income. The

income unit for which the figures are given is also of great importance. A

distribution for individual income recipients always shows very much greater

apparent inequality than a distribution for family units: many of the individuals

are housewives working part-time or receiving a small amount of property

income, or other family members in a similar position. Is the distribution that is

relevant for families one in which the families are classified by total family

income? Or by income per person? Or per equivalent unit? This is no mere

quibble. I believe that the changing distribution of families by number of children

is the most important single factor that has reduced inequality of levels of living

in this country during the past half century. It has been far more important than

graduated inheritance and income taxes. The really low levels of living were the

joint product of relatively low family incomes and relatively large numbers of

children. The average number of children has declined and, even more

important, this decline has been accompanied and largely produced by a virtual

elimination of the very large family. As a result, families now tend to differ much

less with respect to number of children. Yet this change would not be reflected in

a distribution of families by the size of total family income.

A major problem in interpreting evidence on the distribution of income is

the need to distinguish two basically different kinds of inequality; temporary,

short-run differences in income, and differences in long-run income status.

Consider two societies that have the same distribution of annual income. In one

there is great mobility and change so that the position of particular families in

the income hierarchy varies widely from year to year. In the other, there is great

rigidity so that each family stays in the same position year after year. Clearly, in

any meaningful sense, the second would be the more unequal society. The one

kind of inequality is a sign of dynamic change, social mobility, equality of

opportunity; the other, of a status society. The confusion of these two kinds of

inequality is particularly important, precisely because competitive free-enterprise

capitalism tends to substitute the one for the other. Non-capitalist societies tend

to have wider inequality than capitalist, even as measured by annual income; in

addition, inequality in them tends to be permanent, whereas capitalism

undermines status and introduces social mobility.

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Government Measures Used to alter the Distribution of Income

The methods that governments have used most widely to alter the

distribution of income have been graduated income and inheritance taxation.

Before considering their desirability, it is worth asking whether they have

succeeded in their aim.

No conclusive answer can be given to this question with our present

knowledge. The judgment that follows is a personal, though I hope not utterly

uninformed, opinion, stated, for sake of brevity, more dogmatically than the

nature of the evidence justifies. My impression is that these tax measures have

had a relatively minor, though not negligible, effect in the direction of narrowing

the differences between the average position of groups of families classified by

some statistical measures of income. However, they have also introduced

essentially arbitrary inequalities of comparable magnitude between persons

within such income classes. As a result, it is by no means clear whether the net

effect in terms of the basic objective of equality of treatment or equality of

outcome has been to increase or decrease equality.

The tax rates are on paper both high and highly graduated. But their

effect has been dissipated in two different ways. First, part of their effect has

been simply to make the pre-tax distribution more unequal. This is the usual

incidence effect of taxation. By discouraging entry into activities highly taxedin

this case activities with large risk and non-pecuniary disadvantagesthey raise

returns in those activities. Second, they have stimulated both legislative and

other provisions to evade the taxso-called "loopholes" in the law such as

percentage depletion, exemption of interest on state and municipal bonds,

specially favorable treatment of capital gains, expense accounts, other indirect

ways of payment, conversion of ordinary income to capital gains, and so on in

bewildering number and kind. The effect has been to make the actual rates

imposed far lower than the nominal rates and, perhaps more important, to make

the incidence of the taxes capricious and unequal. People at the same economic

level pay very different taxes depending on the accident of the source of their

income and the opportunities they have to evade the tax. If present rates were

made fully effective, the effect on incentives and the like might well be so

serious as to cause a radical loss in the productivity of the society. Tax avoidance

may therefore have been essential for economic wellbeing. If so, the gain has

been bought at the cost of a great waste of resources, and of the introduction of

widespread inequity. A much lower set of nominal rates, plus a more

comprehensive base through more equal taxation of all sources of income could

be both more progressive in average incidence, more equitable in detail, and less

wasteful of resources.

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This judgment that the personal income tax has been arbitrary in its

impact and of limited effectiveness in reducing inequality is widely shared by

students of the subject, including many who strongly favor the use of graduated

taxation to reduce inequality. They too urge that the top bracket rates be

drastically reduced and the base broadened.

A further factor that has reduced the impact of the graduated tax

structure on inequality of income and wealth is that these taxes are much less

taxes on being wealthy than on becoming wealthy. While they limit the use of

the income from existing wealth, they impede even more strikingly so far as they

are effective the accumulation of wealth. The taxation of the income from the

wealth does nothing to reduce the wealth itself, it simply reduces the level of

consumption and additions to wealth that the owners can support. The tax

measures give an incentive to avoid risk and to embody existing wealth in

relatively stable forms, which reduces the likelihood that existing accumulations

of wealth will be dissipated. On the other side, the major route to new

accumulations is through large current incomes of which a large fraction is saved

and invested in risky activities, some of which will yield high returns. If the

income tax were effective, it would close this route. In consequence, its effect

would be to protect existing holders of wealth from the competition of

newcomers. In practice, this effect is largely dissipated by the avoidance devices

already referred to. It is notable how large a fraction of the new accumuations

have been in oil, where the percentage depletion allowances provide a

particularly easy route to the receipt of tax-free income.

In judging the desirability of graduated income taxation it seems to me

important to distinguish two problems, even though the distinction cannot be

precise in application: first, the raising of funds to finance the expenses of those

governmental activities it is decided to undertake (including perhaps measures to

eliminate poverty discussed in chapter xii); second, the imposition of taxes for

redistributive purposes alone. The former might well call for some measure of

graduation, both on grounds of assessing costs in accordance with benefits and

on grounds of social standards of equity. But the present high nominal rates on

top brackets of income and inheritance can hardly be justified on this ground if

only because their yield is so low.

I find it hard, as a liberal, to see any justification for graduated taxation

solely to redistribute income. This seems a clear case of using coercion to take

from some in order to give to others and thus to conflict head-on with individual

freedom.

All things considered, the personal income tax structure that seems to me

best is a flat-rate tax on income above an exemption, with income defined very

broadly and deductions allowed only for strictly defined expenses of earning

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income. As already suggested in chapter v, I would combine this program with

the abolition of the corporate income tax, and with the requirement that

corporations be required to attribute their income to stockholders, and that

stockholders be required to include such sums on their tax returns. The most

important other desirable changes are the elimination of percentage depletion on

oil and other raw materials, the elimination of tax exemption of interest on state

and local securities, the elimination of special treatment of capital gains, the co-

ordination of income, estate, and gift taxes, and the elimination of numerous

deductions now allowed.

An exemption, it seems to me, can be a justified degree of graduation

(see further discussion in chapter xii). It is very different for 90 per cent of the

population to vote taxes on themselves and an exemption for 10 per cent than

for 90 per cent to vote punitive taxes on the other 10 percent which is in effect

what has been done in the United States. A proportional flat-rate-tax would

involve higher absolute payments by persons with higher incomes for

governmental services, which is not clearly inappropriate on grounds of benefits

conferred. Yet it would avoid a situation where any large numbers could vote to

impose on others taxes that did not also affect their own tax burden.

The proposal to substitute a flat-rate income tax for the present

graduated rate structure will strike many a reader as a radical proposal. And so it

is in terms of concept. For this very reason, it cannot be too strongly emphasized

that it is not radical in terms of revenue yield, redistribution of income, or any

other relevant criterion. Our present income tax rates range from 20 per cent to

91 per cent, with the rate reaching 50 per cent on the excess of taxable incomes

over $ 18,000 for single taxpayers or $ 36,000 for married taxpayers filing joint

returns. Yet a flat rate of 23 1/2 per cent on taxable income as presently

reported and presently defined, that is, above present exemptions and after all

presently allowable deductions, would yield as much revenue as the present

highly graduated rate. 2 In fact, such a flat rate, even with no change whatsoever

in other features of the law, would yield a higher revenue because a larger

amount of taxable income would be reported for three reasons: there would be

less incentive than now to adopt legal but costly schemes that reduce the

amount of taxable income reported (so-called tax avoidance); there would be

less incentive to fail to report income that legally should be reported (tax

evasion); the removal of the disincentive effects of the present structure of rates

would produce a more efficient use of present resources and a higher income.

If the yield of the present highly graduated rates is so low, so also must

be their redistributive effects. This does not mean that they do no harm. On the

contrary. The yield is so low partly because some of the most competent men in

the country devote their energies to devising ways to keep it so low; and

because many other men shape their activities with one eye on tax effects. All

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this is sheer waste. And what do we get for it? At most, a feeling of satisfaction

on the part of some that the state is redistributing income. And even this feeling

is founded on ignorance of the actual effects of the graduated tax structure, and

would surely evaporate if the facts were known.

To return to the distribution of income, there is a clear justification for

social action of a very different kind than taxation to affect the distribution of

income. Much of the actual inequality derives from imperfections of the market.

Many of these have themselves been created by government action or could be

removed by government action. There is every reason to adjust the rules of the

game so as to eliminate these sources of inequality. For example, special

monopoly privileges granted by government, tariffs, and other legal enactments

benefiting particular groups, are a source of inequality. The removal of these, the

liberal will welcome. The extension and widening of educational opportunities

has been a major factor tending to reduce inequalities. Measures such as these

have the operational virtue that they strike at the sources of inequality rather

than simply alleviating the symptoms.

The distribution of income is still another area in which government has

been doing more harm by one set of measures than it has been able to undo by

others. It is another example of the justification of government intervention in

terms of alleged defects of the private enterprise system when many of the

phenomena of which champions of big government complain are themselves the

creation of government, big and small.

1 Principles of Political Economy (Ashley edition; London: Longmans, Green &

Co., 1909), p. 751.

2 This point is so important that it may be worth giving the figures and

calculations. The latest year for which figures are available as this is written is

the taxable year 1959 in U.S. Internal Revenue Service, Statistics of Income for

1959. For that year: Aggregate taxable income reported on

Individual tax returns $166,540 million

Income Tax before tax credit 39,092 million

I ncome tax after tax credit. 38,645 million

A flat rate tax of 23 1/2 per cent on the aggregate taxable income would

have yielded (.235) x $ 166,540 million = $ 39,137 million.

If we assume the same tax credit, the final yield would have been about

the same as that actually attained.

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Chapter XI

Social Welfare Measures

The humanitarian and egalitarian sentiment which helped produce the

steeply graduated individual income tax has also produced a host of other

measures directed at promoting the "welfare" of particular groups. The most

important single set of measures is the bundle misleadingly labeled "social

security." Others are public housing, minimum wage laws, farm price supports,

medical care for particular groups, special aid programs, and so on.

I shall first discuss briefly a few of the latter, mostly to indicate how

different their actual effects may be from those intended, and shall then discuss

at somewhat greater length the largest single component of the social security

program, old age and survivor's insurance.

Miscellaneous Welfare Measures

I. Public Housing One argument frequently made for public housing is

based on an alleged neighborhood effect: slum districts in particular, and other

low quality housing to a lesser degree, are said to impose higher costs on the

community in the form of fire and police protection. This literal neighborhood

effect may well exist. But insofar as it does, it alone argues, not for public

housing, but for higher taxes on the kind of housing that adds to social costs

since this would tend to equalize private and social cost.

It will be answered at once that the extra taxes would bear on low-income

people and that this is undesirable. The answer means that public housing is

proposed not on the ground of neighborhood effects but as a means of helping

low-income people. If this be the case, why subsidize housing in particular? If

funds are to be used to help the poor, would they not be used more effectively

by being given in cash rather than in kind? Surely, the families being helped

would rather have" a given sum in cash than in the form of housing. They could

themselves spend the money on housing if they so desired. Hence, they would

never be worse off if given cash; if they regarded other needs as more

important, they would be better off. The cash subsidy would solve the

neighborhood effect as well as the subsidy in kind, since if it were not used to

buy housing it would be available to pay extra taxes justified by the

neighborhood effect.

Public housing cannot therefore be justified on the grounds either of

neighborhood effects or of helping poor families. It can be justified, if at all, only

on grounds of paternalism; that the families being helped "need" housing more

than they "need" other things but would themselves either not agree or would

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spend the money unwisely. The liberal will be inclined to reject this argument for

responsible adults. He cannot completely reject it in the more indirect form in

which it affects children; namely, that parents will neglect the welfare of the

children, who "need" the better housing. But he will surely demand evidence

much more persuasive and to the point than the kind usually given before he can

accept this final argument as adequate justification for large expenditures on

public housing.

So much could have been said in the abstract, in advance of actual

experience with public housing. Now that we have had experience, we can go

much farther. In practice, public housing has turned out to have effects very

different indeed from those intended.

Far from improving the housing of the poor, as its proponents expected,

public housing has done just the reverse. The number of dwelling units

destroyed in the course of erecting public housing projects has been far larger

than the number of new dwelling units constructed. But public housing as such

has done nothing to reduce the number of persons to be housed. The effect of

public housing has therefore been to raise the number of persons per dwelling

unit. Some families have probably been better housed than they would otherwise

have been those who were fortunate enough to get occupancy of the publicly

built units. But this has only made the problem for the rest all the worse, since

the average density of all together went up.

Of course, private enterprise offset some of the deleterious effect of the

public housing program by conversion of existing quarters and construction of

new ones for either the persons directly displaced or, more generally, the

persons displaced at one or two removes in the game of musical chairs set in

motion by the public housing projects. However, these private resources would

have been available in the absence of the public housing program.

Why did the public housing program have this effect? For the general

reason we have stressed time and again. The general interest that motivated

many to favor instituting the program is diffuse and transitory. Once the program

was adopted, it was bound to be dominated by the special interests that it could

serve. In this case, the special interests were those local groups that were

anxious to have blighted areas cleared and refurbished, either because they

owned property there or because the blight was threatening local or central

business districts. Public housing served as a convenient means to accomplish

their objective, which required more destruction than construction.

Even so, "urban blight" is still with us in undiminished force, to judge by

the growing pressure for federal funds to deal with it.

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Another gain its proponents expected from public housing was the

reduction of juvenile delinquency by improving housing conditions. Here again,

the program in many instances had precisely the opposite effect, entirely aside

from its failure to improve average housing conditions. The income limitations

quite properly imposed for the occupancy of public housing at subsidized rentals

have led to a very high density of "broken" families in particular, divorced or

widowed mothers with children. Children of broken families are especially likely

to be "problem" children and a high concentration of such children is likely to

increase juvenile delinquency. One manifestation has been the very adverse

effect on schools in the neighborhood of a public housing project. Whereas a

school can readily absorb a few "problem" children it is very difficult for it to

absorb a large number. Yet in some cases, broken families are a third or more of

the total in a public housing project and the project may account for a majority

of the children in the school. Had these families been assisted through cash

grants, they would have been spread much more thinly through the community.

2. Minimum wage laws Minimum wage laws are about as clear a case as

one can find of a measure the effects of which are precisely the opposite of

those intended by the men of good will who support it. Many proponents of

minimum wage laws quite properly deplore extremely low rates; they regard

them as a sign of poverty; and they hope, by outlawing wage rates below some

specified level, to reduce poverty. In fact, insofar as minimum wage laws have

any effect at all, their effect is clearly to increase poverty. The state can legislate

a minimum wage rate. It can hardly require employers to hire at that minimum

all who were formerly employed at wages below the minimum. It is clearly not in

the interest of employers to do so. The effect of the minimum wage is therefore

to make unemployment higher than it otherwise would be. Insofar as the low

wage rates are in fact a sign of poverty, the people who are rendered

unemployed are precisely those who can least afford to give up the income they

had been receiving, small as it may appear to the people voting for the minimum

wage.

This case is in one respect very much like public housing. In both, the

people who are helped are visible the people whose wages are raised; the

people who occupy the publicly built units. The people who are hurt are

anonymous and their problem is not clearly connected to its cause: the people

who join the ranks of the unemployed or, more likely, are never employed in

particular activities because of the existence of the minimum wage and are

driven to even less remunerative activities or to the relief rolls; the people who

are pressed ever closer together in the spreading slums that seem to be rather a

sign of the need for more public housing than a consequence of the existing

public housing.

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A large part of the support for minimum wage laws comes not from

disinterested men of good will but from interested parties. For example, northern

trade unions and northern firms threatened by southern competition favor

minimum wage laws to reduce the competition from the South.

3. Farm price supports Farm price supports are another example. Insofar

as they can be justified at all on grounds other than the political fact that rural

areas are over-represented in the electoral college and Congress, it must be on

the belief that farmers on the average have low incomes. Even if this be

accepted as a fact, farm price supports do not accomplish the intended purpose

of helping the farmers who need help. In the first place, benefits arc, if anything,

inverse to need, since they are in proportion to the amount sold on the market.

The impecunious farmer not only sells less on the market than the wealthier

farmer; in addition, he gets a larger fraction of his income from products grown

for his own use, and these do not qualify for the benefits. In the second place,

the benefits, if any, to farmers from the price-support program are much smaller

than the total amount spent. This is clearly true of the amount spent for storage

and similar costs which does not go to the farmer at all indeed the suppliers of

storage capacity and facilities may well be the major beneficiaries. It is equally

true of the amount spent to purchase agricultural products. The farmer is

thereby induced to spend additional sums on fertilizer, seed, machinery, etc. At

most, only the excess adds to his income. And finally, even this residual of a

residual overstates the gain since the effect of the program has been to keep

more people on the farm than would otherwise have stayed there. Only the

excess, if any, of what they can earn on the farm with the price-support program

over what they can earn off the farm, is a net benefit to them. The main effect

of the purchase program has simply been to make farm output larger, not to

raise the income per farmer.

Some of the costs of the farm purchase program are so obvious and well-

known as to need little more than mention: the consumer has paid twice, once in

taxes for farm benefit payments, again by paying a higher price for food; the

farmer has been saddled with onerous restrictions and detailed centralized

control; the nation has been saddled with a spreading bureaucracy. There is,

however, one set of costs which is less well known. The farm program has been

a major hindrance in the pursuit of foreign policy. In order to maintain a higher

domestic than world price, it has been necessary to impose quotas on imports

for many items. Erratic changes in our policy have had serious adverse effects on

other countries. A high price for cotton encouraged other countries to enlarge

their cotton production. When our high price led to an unwieldy stock of cotton,

we proceeded to sell overseas at low prices and imposed heavy losses on the

producers whom we had by our earlier actions encouraged to expand output.

The list of similar cases could be multiplied.

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Old Age and Survivor's Insurance

The "social security" program is one of those things on which the tyranny

of the status quo is beginning to work its magic. Despite the controversy that

surrounded its inception, it has come to be so much taken for granted that its

desirability is hardly questioned any longer. Yet it involves a large-scale invasion

into the personal lives of a large fraction of the nation without, so far as I can

see, any justification that is at all persuasive, not only on liberal principles, but

on almost any other. I propose to examine the biggest phase of it, that which

involves payments to the aged.

As an operational matter, the program known as old age and survivor's

insurance (OASI) consists of a special tax imposed on payrolls, plus payments to

persons who have reached a specified age, of amounts determined by the age at

which payments begin, family status, and prior earning record.

As an analytical matter, OASI consists of three separable elements:

1. The requirement that a wide class of persons must purchase specified

annuities, i.e., compulsory provision for old age.

2. The requirement that the annuity must be purchased from the

government; i.e., nationalization of the provision of these annuities.

3. A scheme for redistributing income, insofar as the value of the

annuities to which people are entitled when they enter the system is not equal to

the taxes they will pay.

Clearly, there is no necessity for these elements to be combined. Each

individual could be required to pay for his own annuity; the individual could be

permitted to purchase an annuity from private firms; yet individuals could be

required to purchase specified annuities. The government could go into the

business of selling annuities without compelling individuals to buy specified

annuities and require the business to be self-supporting. And clearly the

government can and does engage in redistribution without using the device of

annuities.

Let us therefore consider each of these elements in turn to see how far, if

at all, each can be justified. It will facilitate our analysis, I believe, if we consider

them in reverse order.

1. Income redistribution. The present OASI program involves two major

kinds of redistribution; from some OASI beneficiaries to others; from the general

taxpayer to OASI beneficiaries.

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The first kind of redistribution is primarily from those who entered the

system relatively young, to those who entered it at an advanced age. The latter

are receiving, and will for some time be receiving, a greater amount as benefits

than the taxes they paid could have purchased. Under present tax and benefit

schedules, on the other hand, those who entered the system at a young age will

receive decidedly less.

I do not see any grounds liberal or other on which this particular

redistribution can be defended. The subsidy to the beneficiaries is independent

of their poverty or wealth; the man of means receives it as much as the indigent.

The tax which pays the subsidy is a flat-rate tax on earnings up to a maximum.

It constitutes a larger fraction of low incomes than of high. What conceivable

justification is there for taxing the young to subsidize the old regardless of the

economic status of the old; for imposing a higher rate of tax for this purpose on

the low incomes than on the high; or, for that matter, for raising the revenues to

pay the subsidy by a tax on payrolls?

The second kind of redistribution arises because the system is not likely to

be fully self-financing. During the period when many were covered and paying

taxes, and few had qualified for benefits, the system appeared to be self-

financing and indeed to be having a surplus. But this appearance depends on

neglecting the obligation being accumulated with respect to the persons paying

the tax. It is doubtful that the taxes paid have sufficed to finance the

accumulated obligation. Many experts assert that even on a cash basis, a subsidy

will be required. And such a subsidy generally has been required in similar

systems in other countries. This is a highly technical matter which we cannot and

need not go into here and about which there can be honest differences of

opinion.

For our purpose, it is enough to ask only the hypothetical question

whether a subsidy from the general taxpayer could be justified if it is required. I

see no grounds on which such a subsidy can be justified. We may wish to help

poor people. Is there any justification for helping people whether they are poor

or not because they happen to be a certain age? Is this not an entirely arbitrary

redistribution?

The only argument I have ever come across to justify the redistribution

involved in OASI is one that I regard as thoroughly immoral despite its wide use.

This argument is that OASI redistribution on the average helps low-income

people more than high-income people despite a large arbitrary element; that it

would be better to do this redistribution more efficiently; but that the community

will not vote for the redistribution directly though it will vote for it as part of a

social security package. In essence, what this argument says is that the

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community can be fooled into voting for a measure that it opposes by presenting

the measure in a false guise. Needless to say, the people who argue this way are

the loudest in their condemnation of "misleading" commercial advertising! 1

2. Nationalization of the provision of required annuities Suppose we avoid

redistribution by requiring each person to pay for the annuity he gets, in the

sense of course, that the premium suffices to cover the present value of the

annuity, account being taken both of mortality and interest returns. What

justification is there then for requiring him to purchase it from a governmental

concern? If redistribution is to be accomplished, clearly the taxing power of the

government must be used. But if redistribution is to be no part of the program

and, as we have just seen, it is hard to see any justification for making it part,

why not permit individuals who wish to do so to purchase their annuities from

private concerns? A close analogy is provided by state laws requiring compulsory

purchase of automobile liability insurance. So far as I know, no state which has

such a law even has a state insurance company, let alone compels automobile

owners to buy their insurance from a government agency.

Possible economies of scale are no argument for nationalizing the

provision of annuities. If they are present, and the government sets up a concern

to sell annuity contracts, it may be able to undersell competitors by virtue of its

size. In that case, it will get the business without compulsion. If it cannot

undersell them, then presumably economics of scale are not present or are not

sufficient to overcome other diseconomies of governmental operation.

One possible advantage of nationalizing the provision of annuities is to

facilitate the enforcement of compulsory purchase of annuities. However, this

seems a rather trivial advantage. It would be easy to devise alternative

administrative arrangements, such as requiring individuals to include a copy of a

receipt for premium payments along with their income tax returns; or having

their employers certify to their having met the requirement. The administrative

problem would surely be minor compared with that imposed by the present

arrangements.

The costs of nationalization seem clearly to outweigh any such trivial

advantage. Here, as elsewhere, individual freedom to choose, and competition of

private enterprises for custom, would promote improvements in the kinds of

contracts available, and foster variety and diversity to meet individual need. On

the political level, there is the obvious gain from avoiding an expansion in the

scale of governmental activity and the indirect threat to freedom of every such

expansion.

Some less obvious political costs arise from the character of the present

program. The issues involved become very technical and complex. The layman is

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often incompetent to judge them. Nationalization means that the bulk of the

"experts" become employees of the nationalized system, or university people

closely linked with it. Inevitably, they come to favor its expansion, not, I hasten

to add, out of narrow self-interest but because they are operating within a

framework in which they take for granted governmental administration and are

familiar only with its techniques. The only saving grace in the United States so

far has been the existence of private insurance companies involved in similar

activities.

Effective control by Congress over the operations of such agencies as the

Social Security Administration becomes essentially impossible as a result of the

technical character of their task and their near-monopoly of experts. They

become self-governing bodies whose proposals are in the main rubber-stamped

by Congress. The able and ambitious men who make their careers in them are

naturally anxious to expand the scope of their agencies and it is exceedingly

difficult to prevent them from doing so. If the expert says yea, who is there

competent to say nay? So we have seen an increasing fraction of the population

drawn into the social security system, and now that there remain few possibilities

of expansion in that direction, we are seeing a move toward the addition of new

programs, such as medical care.

I conclude that the case against the nationalization of the provision of

annuities is exceedingly strong, not only in terms of liberal principles but even in

terms of the values expressed by proponents of the welfare state. If they believe

that the government can provide the service better than the market, they should

favor a government concern to issue annuities in open competition with other

concerns. If they are right, the government concern will prosper. If they are

wrong, the welfare of the people will be advanced by having a private

alternative. Only the doctrinaire socialist, or the believer in centralized control for

its own sake, can, so far as I can see, take a stand on principle in favor of

nationalization of the provision of annuities.

3. Compulsory Purchase of Annuities Having cleared away the underbrush,

we are now ready to face the key issue: compelling individuals to use some of

their current income to purchase annuities to provide for their old age.

One possible justification for such compulsion is strictly paternalistic.

People could if they wished decide to do individually what the law requires them

to do as a group. But they are separately short-sighted and improvident. "We"

know better than "they" that it is in their own good to provide for their old age to

a greater extent than they would voluntarily; we cannot persuade them

individually; but we can persuade 51 per cent or more to compel all to do what is

in their own good. This paternalism is for responsible people, hence docs not

even have the excuse of concern for children or madmen.

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This position is internally consistent and logical. A thoroughgoing

paternalist who holds it cannot be dissuaded by being shown that he is making a

mistake in logic. He is our opponent on grounds of principle, not simply a well-

meaning but misguided friend. Basically, he believes in dictatorship, benevolent

and maybe majoritarian, but dictatorship none the less.

Those of us who believe in freedom must believe also in the freedom of

individuals to make their own mistakes. If a man knowingly prefers to live for

today, to use his resources for current enjoyment, deliberately choosing a

penurious old age, by what right do we prevent him from doing so? We may

argue with him, seek to persuade him that he is wrong, but are we entitled to

use coercion to prevent him from doing what he chooses to do? Is there not

always the possibility that he is right and that we are wrong? Humility is the

distinguishing virtue of the believer in freedom; arrogance, of the paternalist.

Few people are thoroughgoing paternalists. It is a position that is most

unattractive if examined in the cold light of the day. Yet the paternalistic

argument has played so large a role in measures like social security that it seems

worth making it explicit.

A possible justification on liberal principles for compulsory purchase of

annuities is that the improvident will not suffer the consequence of their own

action but will impose costs on others. We shall not, it is said, be willing to see

the indigent aged suffer in dire poverty. We shall assist them by private and

public charity. Hence the man who does not provide for his old age will become

a public charge. Compelling him to buy an annuity is justified not for his own

good but for the good of the rest of us.

The weight of this argument clearly depends on fact. If 90 per cent of the

population would become charges on the public at age 65 in the absence of

compulsory purchase of annuities, the argument would have great weight. If

only 1 per cent would, the argument has none. Why restrict the freedom of 99

per cent to avoid the costs that the other 1 per cent would impose on the

community?

The belief that a large fraction of the community would become public

charges if not compelled to purchase annuities owed its plausibility, at the time

OASI was enacted, to the Great Depression. In every year from 1931 through

1940, more than one-seventh of the labor force was unemployed. And

unemployment was proportionately heavier among the older workers. This

experience was unprecedented and has not been repeated since. It did not arise

because people were improvident and failed to provide for their old age. It was a

consequence, as we have seen, of government mismanagement. OASI is a cure,

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if cure it be at all, for a very different malady and one of which we have had no

experience.

The unemployed of the 1930's certainly created a serious problem of the

relief of distress, of many people becoming public charges. But old-age was by

no means the most serious problem. Many people in productive ages were on

the relief or assistance rolls. And the steady spread of OASI, until today more

than sixteen million persons receive benefits, has not prevented a continued

growth in the number receiving public assistance.

Private arrangements for the care of the aged have altered greatly over

time. Children were at one time the major means whereby people provided for

their own old age. As the community became more affluent, the mores changed.

The responsibilities imposed on children to care for their parents declined and

more and more people came to make provision for old age in the form of

accumulating property or acquiring private pension rights. More recently, the

development of pension plans over and above OASI has accelerated. Indeed,

some students believe that a continuation of present trends points to a society in

which a large fraction of the public scrimps in their productive years to provide

themselves with a higher standard of life in old age than they ever enjoyed in

the prime of life. Some of us may think such a trend perverse, but if it reflects

the tastes of the community, so be it.

Compulsory purchase of annuities has therefore imposed large costs for

little gain. It has deprived all of us of control over a sizable fraction of our

income, requiring us to devote it to a particular purpose, purchase of a

retirement annuity, in a particular way, by buying it from a government concern.

It has inhibited competition in the sale of annuities and the development of

retirement arrangements. It has given birth to a large bureaucracy that shows

tendencies of growing by what it feeds on, of extending its scope from one area

of our life to another. And all this, to avoid the danger that a few people might

become charges on the public.

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1 Another current example of the same argument is in connection with proposals

for federal subsidies for schooling (misleadingly labeled, "aid to education"). A

case can be made for using federal funds to supplement schooling expenditures

in the states with the lowest incomes, on the grounds that the children schooled

may migrate to other states. There is no case whatsoever for imposing taxes on

all the states and giving federal subsidies to all the states. Yet every bill

introduced into Congress provides for the latter and not the former. Some

proponents of these bills, who recognize that only subsidies to some states can

be justified, defend their position by saying that a bill providing only for such

subsidies could not be passed and that the only way to get disproportionate

subsidies to poorer states is to include them in a bill providing subsidies to all

states.

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Chapter XI I

The Alleviation of Poverty

The extraordinary economic growth experienced by Western countries

during the past two centuries and the wide distribution of the benefits of free

enterprise have enormously reduced the extent of poverty in any absolute sense

in the capitalistic countries of the West. But poverty is in part a relative matter,

and even in these countries, there are clearly many people living under

conditions that the rest of us label as poverty.

One recourse, and in many ways the most desirable, is private charity. It

is noteworthy that the heyday of laissez-faire, the middle and late nineteenth

century in Britain and the United States, saw an extraordinary proliferation of

private eleemosynary organizations and institutions. One of the major costs of

the extension of governmental welfare activities has been the corresponding

decline in private charitable activities.

It can be argued that private charity is insufficient because the benefits

from it accrue to people other than those who make the giftsagain, a

neighborhood effect. I am distressed by the sight of poverty; I am benefited by

its alleviation; but I am benefited equally whether I or someone else pays for its

alleviation; the benefits of other people's charity therefore partly accrue to me.

To put it differently, we might all of us be willing to contribute to the relief of

poverty, provided everyone else did. We might not be willing to contribute the

same amount without such assurance. In small communities, public pressure can

suffice to realize the proviso even with private charity. In the large impersonal

communities that are increasingly coming to dominate our society, it is much

more difficult for it to do so.

Suppose one accepts, as I do, this line of reasoning as justifying

governmental action to alleviate poverty; to set, as it were, a floor under the

standard of life of every person in the community. There remain the questions,

how much and how. I see no way of deciding "how much" except in terms of the

amount of taxes weby which I mean the great bulk of usare willing to impose on

ourselves for the purpose. The question, "how," affords more room for

speculation.

Two things seem clear. First, if the objective is to alleviate poverty, we

should have a program directed at helping the poor. There is every reason to

help the poor man who happens to be a farmer, not because he is a farmer but

because he is poor. The program, that is, should be designed to help people as

people not as members of particular occupational groups or age groups or wage-

rate groups or labor organizations or industries. This is a defect of farm

programs, general old-age benefits, minimum-wage laws, pro-union legislation,

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tariffs, licensing provisions of crafts or professions, and so on in seemingly

endless profusion. Second, so far as possible the program should, while

operating through the market, not distort the market or impede its functioning.

This is a defect of price supports, minimum-wage laws, tariffs and the like.

The arrangement that recommends itself on purely mechanical grounds is

a negative income tax. We now have an exemption of $ 600 per person under

the federal income tax (plus a minimum 10 per cent flat deduction). If an

individual receives $ 100 taxable income, i.e., an income of $ 100 in excess of

the exemption and deductions, he pays a tax. Under the proposal, if his taxable

income minus $ 100, i.e., $ 100 less than the exemption plus deductions, he

would pay a negative tax, i.e., receive a subsidy. If the rate of subsidy were, say,

50 per cent, he would receive $ 50. If he had no income at all, and, for

simplicity, no deductions, and the rate were constant, he would receive $ 300.

He might receive more than this if he had deductions, for example, for medical

expenses, so that his income less deductions, was negative even before

subtracting the exemption. The rates of subsidy could, of course, be graduated

just as the rates of tax above the exemption are. In this way, it would be

possible to set a floor below which no man's net income (defined now to include

the subsidy) could fallin the simple example $ 300 per person. The precise floor

set would depend on what the community could afford.

The advantages of this arrangement are clear. It is directed specifically at

the problem of poverty. It gives help in the form most useful to the individual,

namely, cash. It is general and could be substituted for the host of special

measures now in effect. It makes explicit the cost borne by society. It operates

outside the market. Like any other measures to alleviate poverty, it reduces the

incentives of those helped to help themselves, but it does not eliminate that

incentive entirely, as a system of supplementing incomes up to some fixed

minimum would. An extra dollar earned always means more money available for

expenditure.

No doubt there would be problems of administration, but these seem to

me a minor disadvantage, if they be a disadvantage at all. The system would fit

directly into our current income tax system and could be administered along with

it. The present tax system covers the bulk of income recipients and the necessity

of covering all would have the by-product of improving the operation of the

present income tax. More important, if enacted as a substitute for the present

rag bag of measures directed at the same end, the total administrative burden

would surely be reduced.

A few brief calculations suggest also that this proposal could be far less

costly in money, let alone in the degree of governmental intervention involved,

than our present collection of welfare measures. Alternatively, these calculations

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can be regarded as showing how wasteful our present measures are, judged as

measures for helping the poor.

In 1961, government amounted to something like $ 33 billion (federal,

state, and local) on direct welfare payments and programs of all kinds: old age

assistance, social security benefit payments, aid to dependent children, general

assistance, farm price support programs, public housing, etc.l I have excluded

veterans' benefits in making this calculation. I have also made no allowance for

the direct and indirect costs of such measures as minimum-wage laws, tariffs,

licensing provisions, and so on, or for the costs of public health activities, state

and local expenditures on hospitals, mental institutions, and the like.

There are approximately 57 million consumer units (unattached individuals

and families) in the United States. The 1961 expenditures of $ 33 billion would

have financed outright cash grants of nearly $ 6,000 per consumer unit to the 10

per cent with the lowest incomes. Such grants would have raised their incomes

above the average for all units in the United States. Alternatively, these

expenditures would have financed grants of nearly $ 3,000 per consumer unit to

the 20 per cent with the lowest incomes. Even if one went so far as that one-

third whom New Dealers were fond of calling ill-fed, ill-housed, and illclothed,

1961 expenditures would have financed grants of nearly $ 2,000 per consumer

unit, roughly the sum which, after allowing for the change in the level of prices,

was the income which separated the lower one-third in the middle 1930's from

the upper two-thirds. Today, fewer than one-eighth of consumer units have an

income, adjusted for the change in the level of prices, as low as that of the

lowest third in the middle 1930's.

Clearly, these are all far more extravagant programs than can be justified

to "alleviate poverty" even by a rather generous interpretation of that term. A

program which supplemented the incomes of the 20 per cent of the consumer

units with the lowest incomes so as to raise them to the lowest income of the

rest would cost less than half of what we are now spending.

The major disadvantage of the proposed negative income tax is its

political implications. It establishes a system under which taxes are imposed on

some to pay subsidies to others. And presumably, these others have a vote.

There is always the danger that instead of being an arrangement under which

the great majority tax themselves willingly to help an unfortunate minority, it will

be converted into one under which a majority imposes taxes for its own benefit

on an unwilling minority. Because this proposal makes the process so explicit,

the danger is perhaps greater than with other measures. I see no solution to this

problem except to rely on the self-restraint and good will of the electorate.

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Writing about a corresponding problem British old-age pensions in 1914,

Dicey said, "Surely a sensible and a benevolent man may well ask himself

whether England as a whole will gain by enacting that the receipt of poor relief,

in the shape of a pension, shall be consistent with the pensioner's retaining the

right to join in the election of a Member of Parliament." 2

The verdict of experience in Britain on Dicey's question must as yet be

regarded as mixed. England did move to universal suffrage without the

disfranchisement of either pensioners or other recipients of state aid. And there

has been an enormous expansion of taxation of some for the benefit of others,

which must surely be regarded as having retarded Britain's growth, and so may

not even have benefited most of those who regard themselves as on the

receiving end. But these measures have not destroyed, at least as yet, Britain's

liberties or its predominantly capitalistic system. And, more important, there have

been some signs of a turning of the tide and of the exercise of self-restraint on

the part of the electorate.

Liberalism and Egalitamanism

The heart of the liberal philosophy is a belief in the dignity of the

individual, in his freedom to make the most of his capacities and opportunities

according to his own lights, subject only to the proviso that he not interfere with

the freedom of other individuals to do the same. This implies a belief in the

equality of men in one sense; in their inequality in another. Each man has an

equal right to freedom. This is an important and fundamental right precisely

because men are different, because one man will want to do different things with

his freedom than another, and in the process can contribute more than another

to the general culture of the society in which many men live.

The liberal will therefore distinguish sharply between equality of rights and

equality of opportunity, on the one hand, and material equality or equality of

outcome on the other. He may welcome the fact that a free society in fact tends

toward greater material equality than any other yet tried. But he will regard this

as a desirable by-product of a free society, not its major justification. He will

welcome measures that promote both freedom and equalitysuch as measures to

eliminate monopoly power and to improve the operation of the market. He will

regard private charity directed at helping the less fortunate as an example of the

proper use of freedom. And he may approve state action toward ameliorating

poverty as a more effective way in which the great bulk of the community can

achieve a common objective. He will do so with regret, however, at having to

substitute compulsory for voluntary action.

The egalitarian will go this far, too. But he will want to go further. He will

defend taking from some to give to others, not as a more effective means

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whereby the "some" can achieve an objective they want to achieve, but on

grounds of "justice." At this point, equality comes sharply into conflict with

freedom; one must choose. One cannot be both an egalitarian, in this sense, and

a liberal.

1 This figure is equal to government transfer payments ($ 31.1 billion) less

veterans' benefits ($ 4.8 billion), both from the Department of Commerce

national income accounts, plus federal expenditures on the agricultural program

($ 5.5 billion) plus federal expenditures on public housing and other aids to

housing ($ 0.5 billion), both for year ending June 30, 1961 from Treasury

accounts, plus a rough allowance of $ 0.7 billion to raise it to even billions and to

allow for administrative costs ot federal programs, omitted state and local

programs, and miscellaneous items. My guess is that this figure is a substantial

underestimate.

2 A. V. Dicey, Law and Public Opinion in England, (2d ed., London: Macmillan,

1914), p. xxxv.

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Chapter XI 1 1

Conclusion

In the 1920's and the 1930's, intellectuals in the United States were

overwhelmingly persuaded that capitalism was a defective system inhibiting

economic well-being and thereby freedom, and that the hope for the future lay

in a greater measure of deliberate control by political authorities over economic

affairs. The conversion of the intellectuals was not achieved by the example of

any actual collectivist society, though it undoubtedly was much hastened by the

establishment of a communist society in Russia and the glowing hopes placed in

it. The conversion of the intellectuals was achieved by a comparison between the

existing state of affairs, with all its injustices and defects, and a hypothetical

state of affairs as it might be. The actual was compared with the ideal.

At the time, not much else was possible. True, mankind had experienced

many epochs of centralized control, of detailed intervention by the state into

economic affairs. But there had been a revolution in politics, in science, and in

technology. Surely, it was argued, we can do far better with a democratic

political structure, modern tools, and modern science than was possible in earlier

ages.

The attitudes of that time are still with us. There is still a tendency to

regard any existing government intervention as desirable, to attribute all evils to

the market, and to evaluate new proposals for government control in their ideal

form, as they might work if run by able, disinterested men, free from the

pressure of special interest groups. The proponents of limited government and

free enterprise are still on the defensive.

Yet, conditions have changed. We now have several decades of

experience with governmental intervention. It is no longer necessary to compare

the market as it actually operates and government intervention as it ideally might

operate. We can compare the actual with the actual.

If we do so, it is clear that the difference between the actual operation of

the market and its ideal operation great though it undoubtedly is is as nothing

compared to the difference between the actual effects of government

intervention and their intended effects. Who can now see any great hope for the

advancement of men's freedom and dignity in the massive tyranny and

despotism that hold sway in Russia? Wrote Marx and Engels in The Communist

Manifesto: "The proletarians have nothing to lose but their chains. They have a

world to win." Who today can regard the chains of the proletarians in the Soviet

Union as weaker than the chains of the proletarians in the United States, or

Britain or France or Germany or any Western state?

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Let us look closer to home. Which if any of the great "reforms" of past

decades has achieved its objectives? Have the good intentions of the proponents

of these reforms been realized?

Regulation of the railroads to protect the consumer quickly became an

instrument whereby the railroads could protect themselves from the competition

of newly emerging rivals at the expense, of course, of the consumer.

An income tax initially enacted at low rates and later seized upon as a

means to redistribute income in favor of the lower classes has become a facade,

covering loopholes and special provisions that render rates that arc highly

graduated on paper largely ineffective. A flat rate of 23 1/2 per cent on presently

taxable income would yield as much revenue as the present rates graduated

from 20 to 91 per cent. An income tax intended to reduce inequality and

promote the diffusion of wealth has in practice fostered reinvestment of

corporate earnings, thereby favoring the growth of large corporations, inhibiting

the operation of the capital market, and discouraging the establishment of new

enterprises.

Monetary reforms, intended to promote stability in economic activity and

prices, exacerbated inflation during and after World War I and fostered a higher

degree of instability thereafter than had ever been experienced before. The

monetary authorities they established bear primary responsibility for converting a

serious economic contraction into the catastrophe of the Great Depresson from

192933. A system established largely to prevent bank panics produced the most

severe banking panic in American history.

An agricultural program intended to help impecunious farmers and to

remove what were alleged to be basic dislocations in the organization of

agriculture has become a national scandal that has wasted public funds,

distorted the use of resources, riveted increasingly heavy and detailed controls

on farmers, interfered seriously with United States foreign policy, and withal has

done little to help the impecunious farmer.

A housing program intended to improve the housing conditions of the

poor, to reduce juvenile delinquency, and to contribute to the removal of urban

slums, has worsened the housing conditions of the poor, contributed to juvenile

delinquency, and spread urban blight.

In the 1930's, "labor" was synonomous with "labor union" to the

intellectual community; faith in the purity and virtue of labor unions was on a par

with faith in home and motherhood. Extensive legislation was enacted to favor

labor unions and to foster "fair" labor relation. Labor unions waxed in strength.

By the 1950's, "labor union" was almost a dirty word; it as no longer

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synonomous with "labor," no longer automatically to be taken for granted as on

the side of the angels.

Social security measures were enacted to make receipt of assistance a

matter of right, to eliminate the need for direct relief and assistance. Millions

now receive social security benefits. Yet the relief rolls grow and the sums spent

on direct assistance mount.

The list can easily be lengthened: the silver purchase program of the

1930's, public power projects, foreign aid programs of the post-war years,

F.C.C., urban redevelopment programs, the stockpiling program these and many

more have had effects very different and generally quite opposite from those

intended.

There have been some exceptions. The expressways crisscrossing the

country, magnificent dams spanning great rivers, orbiting satellites are all

tributes to the capacity of government to command great resources. The school

system, with all its defects and problems, with all the possibility of improvement

through bringing into more effective play the forces of the market, has widened

the opportunities available to American youth and contributed to the extension of

freedom. It is a testament to the public-spirited efforts of the many tens of

thousands who have served on local school boards and to the willingness of the

public to bear heavy taxes for what they regarded as a public purpose. The

Sherman antitrust laws, with all their problems of detailed administration, have

by their very existence fostered competition. Public health measures have

contributed to the reduction of infectious disease. Assistance measures have

relieved suffering and distress. Local authorities have often provided facilities

essential to the life of communities. Law and order have been maintained,

though in many a large city the performance of even this elementary function of

government has been far from satisfactory. As a citizen of Chicago, I speak

feelingly.

If a balance be struck, there can be little doubt that the record is dismal.

The greater part of the new ventures undertaken by government in the past few

decades have failed to achieve their objectives. The United States has continued

to progress; its citizens have become better fed, better clothed, better housed,

and better transported; class and social distinctions have narrowed; minority

groups have become less disadvantaged; popular culture has advanced by leaps

and bounds. All this has been the product of the initiative and drive of individuals

co-operating through the free market. Government measures have hampered not

helped this development. We have been able to afford and surmount these

measures only because of the extraordinary fecundity of the market. The

invisible hand has been more potent for progress than the visible hand for

retrogression.

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Is it an accident that so many of the governmental reforms of recent

decades have gone awry, that the bright hopes have turned to ashes? Is it

simply because the programs are faulty in detail?

I believe the answer is clearly in the negative. The central defect of these

measures is that they seek through government to force people to act against

their own immediate interests in order to promote a supposedly general interest.

They seek to resolve what is supposedly a conflict of interest, or a difference in

view about interests, not by establishing a framework that will eliminate the

conflict, or by persuading people to have different interests, but by forcing

people to act against their own interest. They substitute the values of outsiders

for the values of participants; either some telling others what is good for them,

or the government taking from some to benefit others. These measures are

therefore countered by one of the strongest and most creative forces known to

man the attempt by millions of individuals to promote their own interests, to live

their lives by their own values. This is the major reason why the measures have

so often had the opposite of the effects intended. It is also one of the major

strengths of a free society and explains why governmental regulation docs not

strangle it.

The interests of which I speak are not simply narrow self-regarding

interests. On the contrary, they include the whole range of values that men hold

dear and for which they are willing to spend their fortunes and sacrifice their

lives. The Germans who lost their lives opposing Adolph Hitler were pursuing

their interests as they saw them. So also are the men and women who devote

great effort and time to charitable, educational, and religious activities. Naturally,

such interests are the major ones for few men. It is the virtue of a free society

that it nonetheless permits these interests full scope and does not subordinate

them to the narrow materialistic interests that dominate the bulk of mankind.

That is why capitalist societies are less materialistic than collectivist societies.

Why is it, in light of the record, that the burden of proof still seems to rest

on those of us who oppose new government programs and who seek to reduce

the already unduly large role of government? Let Dicey answer: "The beneficial

effect of State intervention, especially in the form of legislation, is direct,

immediate, and, so to speak, visible, whilst its evil effects are gradual and

indirect, and lie out of sight. . . . Nor. . . do most people keep in mind that State

inspectors may be incompetent, careless, or even occasionally corrupt . . . ; few

are those who realize the undeniable truth that State help kills self-help. Hence

the majority of mankind must almost of necessity look with undue favor upon

governmental intervention. This natural bias can be counteracted only by the

existence, in a given society, ... of a presumption or prejudice in favor of

individual liberty, that is, of laissez-faire. The mere decline, therefore, of faith in

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self-help and that such a decline has taken place is certain is of itself sufficient to

account for the growth of legislation tending towards socialism." 1

The preservation and expansion of freedom are today threatened from

two directions. The one threat is obvious and clear. It is the external threat

coming from the evil men in the Kremlin who promise to bury us. The other

threat is far more subtle. It is the internal threat coming from men of good

intentions and good will who wish to reform us. Impatient with the slowness of

persuasion and example to achieve the great social changes they envision, they

are anxious to use the power of the state to achieve their ends and confident of

their own ability to do so. Yet if they gained the power, they would fail to

achieve their immediate aims and, in addition, would produce a collective state

from which they would recoil in horror and of which they would be among the

first victims. Concentrated power is not rendered harmless by the good

intentions of those who create it.

The two threats unfortunately reinforce one another. Even if we avoid a

nuclear holocaust, the threat from the Kremlin requires us to devote a sizable

fraction of our resources to our military defense. The importance of government

as a buyer of so much of our output, and the sole buyer of the output of many

firms and industries, already concentrates a dangerous amount of economic

power in the hands of the political authorities, changes the environment in which

business operates and the criteria relevant for business success, and in these

and other ways endangers a free market. This danger we cannot avoid. But we

needlessly intensify it by continuing the present widespread governmental

intervention in areas unrelated to the military defense of the nation and by

undertaking ever new governmental programs from medical care for the aged to

lunar exploration.

As Adam Smith once said, "There is much ruin in a nation". Our basic

structure of values and the interwoven network of free institutions will withstand

much. I believe that we shall be able to preserve and extend freedom despite

the size of the military programs and despite the economic powers already

concentrated in Washington. But we shall be able to do so only if we awake to

the threat that we face, only if we persuade our fellow men that free institutions

offer a surer, if perhaps at times a slower, route to the ends they seek than the

coercive power of the state. The glimmerings of change that are already

apparent in the intellectual climate are a hopeful augury.

1 A. V. Dicey, op. cit., pp. 2578.

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