From The Collected Works of Milton Friedman, compiled and edited by Robert Leeson and Charles G. Palm.

"Inflation: Is It an Incurable Disease?"*

by Milton Friedman

In *Milton Friedman in South Africa*, edited by Meyer Feldberg, Kate Jowell and Stephen Mulholland, pp. 11-20. Cape Town and Johannesburg: Graduate School of Business of the University of Cape Town and The Sunday Times, 1976.

It is a great pleasure to be here with you in South Africa. Although it is a country I have never visited before, I know a good deal about it. My main interest as a scholar has been the history of money and South Africa has played a crucial role in that history. The world inflation which ran from the 1890's to the First World War resulted primarily from the discovery of the cyanide process of gold extraction which opened up the South African gold fields to exploitation.

I have used the title of inflation as a disease – curable or incurable – because that is what inflation really is. In its extreme form, the form which afflicted Germany right after World War One, the slightly less extreme form which is now afflicting Argentina, it is a disease which can destroy a nation. In the less extreme form it can weaken and undermine the productive strength of a nation. We want to ask what is the cause of the disease, what is the cure, what side-effects or unpleasant features will be associated with the cure, and finally, what alternative is there to the cure.

If we turn to the cause of the disease, the first and most important, thing to be said is that inflation is produced by government. I do not mean that it produced out of ill-will or malice. It is produced by government because government responds to the wishes of its constituency. However, every government, whether it be in South Africa or in any other country of the world which embarks on an inflationary course, is quick to blame other people for inflation. You will discover, if you listen to Governmental officials, that inflation has been produced perhaps by the Arab sheiks, perhaps by the greedy businessmen, perhaps by the grasping trade-unionists in countries where they have power, perhaps by the spendthrift consumers.

Then you will find that government will exhort the community to stop the inflation. I read the anti-inflation manifesto issued by the South African Government in September, and it is very much par for the course. There is about one paragraph in it which has some relation to the true cause for inflation; the rest is an attempt to shift the blame for inflation to the other groups in the community. Now there is no doubt whatsoever that the businessmen are greedy, that the trade-unionists are grasping, that consumers are spendthrifts. But none of these groups possesses a printing press on which it can turn out those multi-coloured pieces of paper you call money. The direct cause of inflation is too much money relative to output. There is no other route through which inflation can be produced. There is no inflation in history which has not been preceded by a rapid increase in the quantity of money per unit of output. There is no case that I know of in which you had a rapid increase in the quantity of money relative to output without inflation.

That proposition is the beginning of the understanding of inflation but it is a proposition which people find very hard to accept. To persuade you that it's at least worth thinking about I have a few charts to illustrate the relationship between the quantity of money on the one hand and the price level on the other.

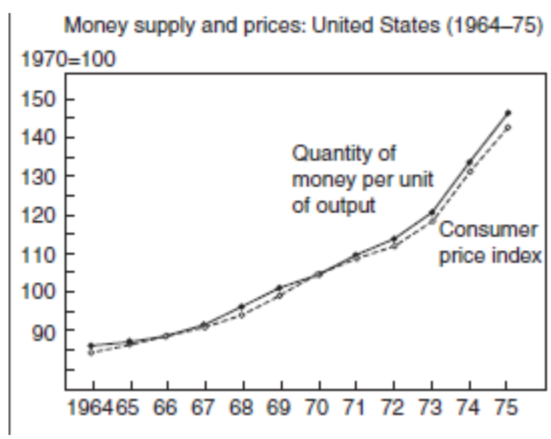
The first chart is for the United States of America for the decade 1964–1975. The quantity of money in the United States per unit of output is expressed with 1970 as 100, so that it's an index number based on 100. The consumer price index is expressed similarly with 1970 as 100. As you can see, there is more than a family similarity between the two curves. (To allow for the time it takes for a change in the quantity of money to take effect, the quantity of money plotted is for a period ended six months earlier than the price index number.)

In Japan, there was a very much more rapid rise in the quantity of money per unit of output and a very much more rapid rise in prices. Again the two charts match one another. You can see too why the United Kingdom is having a violent inflation. The quantity of money per unit of output has been shooting out of sight and so has the consumer price index.

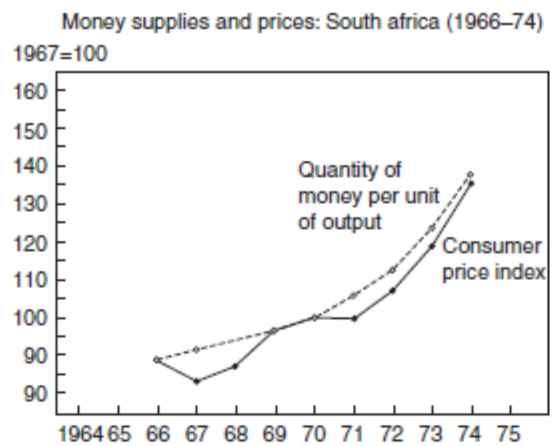
Unfortunately in Chicago we were unable to get the very latest figures on South Africa and so the last year on the final chart is 1974. I believe though, from what I have observed since being here, that adding another year on the chart will not destroy the relationship.

I have shown you the proximate cause of inflation but the question remains: why does the quantity of money increase?

Historically, the reason has very often been an event which has produced a rapid increase in the physical quantity of the monetary metal. In the 1840's and the 1850's gold discoveries in California and Australia produced a rapid increase in the quantity of money and world wide inflation. In the 1890's there was a flood of South African gold.



Note: There is a delay in the impact of a change in the quantity of money. Therefore, the money index measures the quantity of money ("near money") for the fiscal year ending June 30 while output (real GDP) is for the calendar year.



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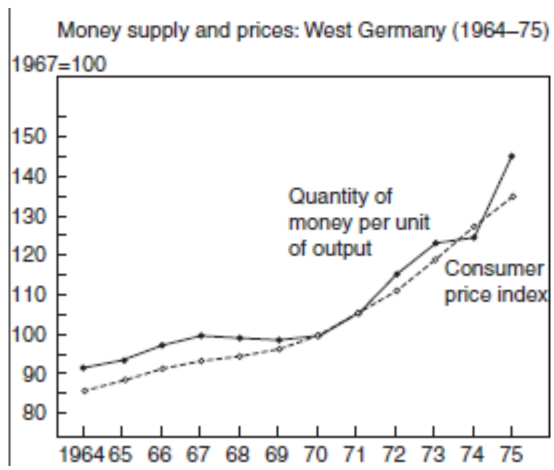
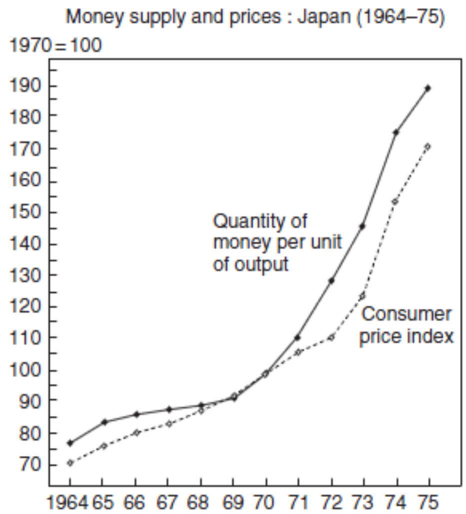


Note: There is a delay in the impact of a change in the quantity of money. Therefore, the money index measures the quantity of money ("new money") for the fiscal year ending June 30 while output (real GDP) is for the calendar year.



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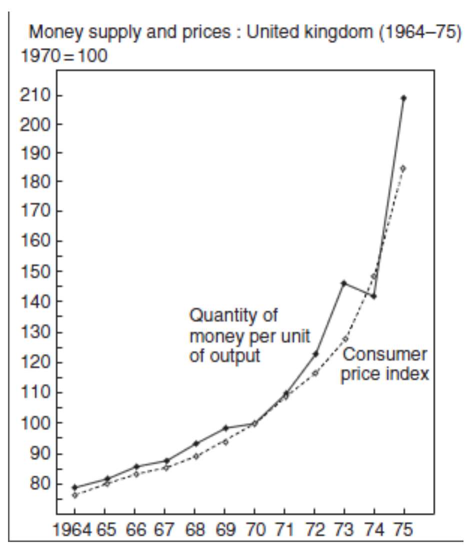

Note: There is a delay in the impact of a change in the quantity of money. Therefore, the money index measures the quantity of money ("new money") for the fiscal year ending June 30 while output (real GDP) is for the calendar year.

But nowadays we have become more sophisticated and no longer rely on the “barbarous” metal gold to keep us in restraint and the main sources of an increase in the quantity of money are no longer changes in the physical supply of the precious metal or of gold. Today money is created by government, either by printing paper or by entering numbers on a ledger.

Why do government monetary authorities increase the quantity of money? There is one reason which has been with us for thousands of years: whenever any sovereign has invariably turned to inflation as the method of taxation, as the method of financing his expenditures. That was as true of the Emperor Diocletian two thousand years ago as it has been of many sovereigns in between. In the old days they did it by introducing alloys into metals so that the silver contents of coins was reduced. In the final years of Diocletian's reign the denarius, once a solid silver coin, had finally been reduced to nothing more than a copper coin with a thin wash of silver. Those were the means whereby the ancient sovereigns inflated the currency in order to provide for their expenditure.

In the modern day we do it, as I say, more elegantly but the fundamental reason is the same. Inflation has a special feature that recommends it particularly to governments when they are subject to strain in their budgets, and that feature is that it is the one form of taxation that can be imposed without anybody voting for it – a form of taxation without any representation.

Your government has imposed upon you a substantial burden of taxation in the past several years, through a rise in the price level, just as my government in the United States has imposed one on us. The tax takes three different forms: in the first place, the depreciation in your cash balances is strictly equivalent to a tax on you for holding cash balances. The extra pieces of paper you have to carry around in your pocket in order to have the same purchasing power are exactly the same as if they were receipts or vouchers for taxes paid. The second way in which inflation is a tax is that with graduated income-taxes the effect of inflation is to push people up into a higher income bracket and thus to raise the effective burden of the tax without any member of Parliament having to vote for it. The third way in which it is a tax is that people who loan money to the government are paid back in depreciated money, and therefore in effect end up paying the government for the privilege of lending money to it. In these three ways inflation produces revenue for the government.

Now I don't believe you ought to blame government. It's the people who insist that government increase its expenditures without increasing taxes. Well then, if you leave the government between a rock and a hard place, it's little wonder that it takes the easy way out, that of permitting inflation to occur. This financing of government spending has been probably the most important single historical source of inflation.

In our modern day, the adoption by government all over the world of full-employment policies is another reason. Whenever there is an economic recession, there is great pressure on the government to increase its spending, to increase its printing of money, in order to relieve unemployment. It can succeed for a time. By printing money and inflating the currency you can temporarily create what appears to be a boom, but when people catch onto what's happening the stimulus disappears. At that point prices rise and you have a combination of both inflation and unemployment.

The first of these two factors, the financing of deficits or expenditures, has been a steady force making for more or less chronic inflation. The second factor, the full-employment policy, has a different effect: it has produced a wave-like pattern of inflation. When the inflation emerges and gets serious there is great pressure on the government to do something about it. It steps on the brake. As soon as the economy slows down it reverses itself and steps on the accelerator, and this produces a kind of roller-coaster, with a generally upward trend. Each trough tends to be higher than the preceding trough, each peak tends to be higher than the preceding peak. We in the United States are today praising ourselves because inflation has been brought down from something like 12 per cent a year to something like maybe five per cent or six per cent a year. The last sentence of Adam Smith's "Wealth of Nations" says that England, if she doesn't make her colonies pay, will have to adjust herself to the mediocrity of her circumstances. Well that's what we do with inflation: we adjust ourselves.

Some of you will ask me, haven't I left out some fundamental causes? These anti-inflation documents put a great deal of emphasis on the influence from abroad and on productivity. Have I not left out something important?

The answer in both cases is no. Inflation cannot be imported. In today's world, in which we do not have a system of rigid exchange rates, in which we have exchange rates which sometimes are pegged but always are subject to change and which more frequently are floating, inflation is strictly a domestic matter. If one country inflates more rapidly than another it has a decline in its exchange rate. If you look at the chart you will see that the exchange value of the British pound has declined by almost exactly the same amount as its inflation exceeds the inflation in the United States. France has inflated more rapidly than Germany so the exchange value of French francs has gone down relative to the exchange value of the Mark. South Africa is at the moment inflating more rapidly than other countries. If it continues to do so, it will be forced, sooner or later, to change its exchange rate as a result of the differences between its inflation rate and the inflation rate of the outside world.

The question on productivity is one of orders of magnitude, South Africa's real output has grown at something like five per cent a year for many years. It would be a miracle if by some feat of management you could raise that five per cent to six per cent. But that's small potatoes compared to the rate at which the quantity of money can be increased. Your quantity of money was increasing a year ago at the rate of at least 20 per cent a year. It is true that if you could increase your output more rapidly that would tend to be anti-inflationary. But as the charts show if you could increase output by one per cent per year more rapidly, that would tend to reduce the inflation rate by only one percentage point. You cannot solve inflation problems by improving productivity; it is just too weak a weapon for that purpose.

Let me turn from the cause to the cure. We know how to stop inflation: stop printing money. In South Africa today, that would require the government to cut down on its expenditures or to increase explicit taxes, or to pay whatever interest rate it must to borrow at home or abroad. That's very simple, very straightforward, but the problem is to have the political will to take one or another of these steps.

It's hard to have the political will because inflation is very closely analogous to the drinking of alcohol. When you go on a binge, the good effects come first, the bad effects come the next morning, when you have a hangover. It's the same with inflation. When a country starts off on a inflationary binge it looks as if everyone is doing well. You're pouring out money, demand for your products is going up, the effect is increased output and employment.

But as people catch on to what's going on, as prices start to rise, the hangover comes. In the process of curing yourself of alcoholism the situation is reversed: the bad effects come first and the good effects come later. It is precisely the same with inflation. If you slow down the rate of growth in the quantity of money, the initial effect is to slow down the rate of growth of the economy, which leads to unemployment. Only when the effect of your measures works itself through the economy will prices start to slow down, inflation eases off and output grows in a healthy, non-inflationary fashion.

It is extremely difficult for politicians to take measures that have initial bad effects. They are engaged in a political market trying to satisfy their customers, the voters. Another obstacle to ending inflation is that most of us gain from inflation. Everybody objects to a rise in the prices in the things he buys but he is delighted at a rise in the prices in the things he sells. I have yet to hear anybody objecting to inflation, who says that what's wrong is that he is able to sell his goods for higher prices. People who own their own homes purchased those homes on mortgages at relatively low interest rates and have seen their mortgage paid off as a result of inflation. And there are many other groups who gain from inflation and who oppose the policies required to eliminate it.

The cure for inflation will therefore involve painful side-effects. But there is no alternative. It is an illusion that somehow or other there's a trade-off that we can simply settle down to a steady rate of inflation and get the benefit of a low rate of unemployment.

What in fact we have had is a rising average rate of inflation and also a rising average rate of unemployment. The reason is because inflation does not affect all items alike with some products adjusting more rapidly than others. Moreover, inflation inevitably produces governmental interventions designed to fix a price here or there. In your particular case, the Government intervened to fix the price of the rand.

These price fixing attempts are bound to fail, but in the process they generate distortions and other interventions. If you peg the price of the rand you have to have exchange control, which means you have to intervene in the decisions of who may buy what, where and how, and the result of this is that you make the market much less efficient than it otherwise would be. You lower production and you increase unemployment. This is the kind of thing that has happened in Great Britain, in the United States, in every country that I know of.

Now note that unemployment is not a cure for inflation, but rather a side-effect of a cure. Wage and price controls are also no solution. We have had two thousand years of experience with wage and price controls and there is yet to be a case in which they have succeeded in holding down or curing inflation. Indeed, the situation is really the reverse. If any government introduces wage and price controls it can be predicted with great confidence that there will be an inflationary burst a year or two later. Governments undertake wage and price controls to give the impression that they are doing something to cure inflation, while they follow inflationary policies. After all governmental officials are in general very smart, they know their history as well as you and I do.

They know wage and price controls suppress the symptoms of inflation but they do not get at the cause.

One of the things that has always fascinated me is the suicidal impulse of businessmen who are often among the strongest supporters of wage and price controls. Fortunately, the United States experience from 1971–3 has temporarily cured businessmen of the delusion that controls will hold down wages rather than prices. In general, workers have more votes than employers, so wage and price controls will always be more effective on prices than on wages.

Given that you take the cure, is there any way that you can minimize the side-effects? What's the economic equivalent of aspirin?

There are two devices which will minimize the painful side-effects of slowing down inflation. One is to undertake the cure gradually. Given that you are in a situation where prices are rising in South Africa – it's something like 11 per cent per year – take two or three years, four years to gradually bring it down. Your goal should be zero, not a modest rate of inflation, but zero. But don't try to do it overnight. Obviously for Argentina with a rate of inflation running at 400–500 per cent a year, it's absurd to tell them that they should slow it down gradually; they must really step on the brake. But if you're in a situation such as South Africa is in, there's a good deal to be said for slowing it down gradually to ease the adjustment.

The second device for easing the adjustment is to index government taxes and government borrowing. For example, the basic exemption on personal income tax should not be a fixed number of rands or fixed number of dollars but a number of rands multiplied by a price index number. Similarly, I think that it is a lack of faith with its citizens for governments to issue bonds and securities, the real value of which is subsequently depreciated by inflation. The person who buys Government Saving Bonds gets interest at the rate of about five or six per cent when price inflation has been higher than that. To add insult to injury he pays income tax on the fake interest he has received. In most cases the poor sucker ends up worse off. This is a great scandal and the government ought to avoid it by indexing its securities. I do not believe in compulsory indexation in the rest of the economy. You ought to have voluntary indexing as far as possible in order to permit long term contracts to be entered into with confidence.

Outside of those two devices I don't know of any other ways to minimize the cost of slowing down inflation once you've gotten into it.

If time permitted, we could go into a much more extensive discussion of an even more basic source of our present predicament: the tendency over the past thirty or forty years to assign ever larger roles to government. This change in attitude has led to greater expenditures which causes governments to resort to inflation as a method of taxation. This expansion in the role of government has also led to governments trying to assume responsibility for full employment.

From the very long-term point of view we shall not solve the problem of inflation unless we are able to change public attitudes towards assigning a smaller instead of a larger role to government, towards cutting government back to a size at which its expenditures match what the public is willing to pay in taxes. I cannot say that there is any very great prospect of that occurring, but I don't believe it's completely hopeless. One of the main allies in our fight to turn the tide of opinion has been the inefficiency and incompetence of government. Another main ally has been the efficiency and competence of ordinary people in finding ways of getting around government regulations. Between the two the effect has been to produce, certainly in my country, a disillusionment with government as the solution to all problems, a greater respect for individual initiative and private enterprise as a way in which people can co-operate with one another without coercion.

I think, however, that if one were to predict the future simply by looking at the past you would have to be very pessimistic. It seems to be extraordinarily difficult for any country to learn from the experience of any other country. I have been in your country only three or four days, but in respect to your inflationary experience I didn't have to be here more than ten minutes. When you go to a continuous movie you say this is where I came in. Well that's the feeling I have here, that I'm seeing a film that I've seen before. The course of events here is identical with the course of events in my country, in Great Britain, in France and in Japan. The most extreme example is the pegging of the Rand to the U.S. Dollar. In 1971 Japan paid five hundred million dollar for the dubious privilege of postponing the appreciation of the yen by three weeks. In 1972 Germany did the same thing for the Mark. The British have tried time and again to hold the pegged rate. I have been trying to find out what is going to enable South Africa to do what Japan could not do. Just a few months ago, you had to recognize the inevitable and devalue the rand, the same thing will happen again if you continue on your present course. Of course, if you were able suddenly to turn around and reduce the rate of inflation to zero while our rate in the United States stays five or six, then maybe you can appreciate. I'm not trying to say whether you'll depreciate or appreciate, I'm only saying that experience over the past twenty years has shown that no country can peg its exchange rate over any long period while it follows an independent internal monetary policy. And yet country after country tries to do it. This inability of countries to learn from other people's experiences is a source of great pessimism.

But I will close on a more optimistic note. The lack of success of all long-term forecasters is a cause for great optimism.

Notes

* An address to 350 Cape Town businessmen, 24 March 1976.

Excerpts printed in *University of Cape Town Graduate School of Business Journal*, 1975-1976, pp. 15-18.

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"The Future of Capitalism"*
by Milton Friedman
In *Milton Friedman in South Africa*, edited by Meyer Feldberg, Kate Jowell and Stephen Mulholland, pp. 21-33. Cape Town and Johannesburg: Graduate School of Business of the University of Cape Town and The Sunday Times, 1976.

The problem of the future of capitalism is really not a problem of economics, nor is it a problem simply of an enterprise system; it is fundamentally the problem of the future of freedom.

There is no country at any time in the history of the world that has been able to maintain a free political system unless the greater part of the resources of that country were organized by a free, private enterprise, capitalist system.

There is no exception, and hence, if we do not succeed in maintaining in a considerable part of what we now call the West – a shrinking area unfortunately – the essentials of a free enterprise system we shall not be able to maintain our personal and our individual freedoms.

The word “capitalism”, when you talk about the future of capitalism, is, by itself, not a very good description. It is, in fact, a very misleading description because every important society and every major economic group is in a large part capitalist. After all, the Soviet Union has a great amount of amassed capital, as has the United States. However, the distinction that is important is not between private capitalism and government capitalism. In every society most of the capital, properly defined, is privately owned. The most important source of productive capacity in any society, including the Soviet Union, is the skills and the abilities of the human beings who compose it.

And there is a sense in which even in the Soviet Union that labour power, that human ability, belongs to the individuals, although I recognize that in a society as authoritarian as the Soviet Union that is a limited sense.

The important distinction is not even the extent to which the market system is used although in principle you can distinguish two very different ways of organizing economic activity.

On the one hand you have the command economy which is like an army, in which the General tells the Colonel, the Colonel tells the Major and the Major tells the Lieutenant, and so on down the line; on the other hand you have an economy operating on the basis of voluntary co-operation, of purchase and sale through the market. Although, in principle, these are two different ways in which you can organize economic activity, in practice no complex society can operate strictly on the command principle. It is impossible.

There is no way in which people at the centre can know enough about all of the details of society, about what’s happening everywhere, to be able to send the orders up and down the chain of command so as to achieve the desired results.

Even in a country which is as centralized and as collectivist as the Soviet Union I venture to suggest that the great bulk of all organization of economic activity in that country is carried on through market activities.

Take some very simple examples. The Soviet Union explicitly permits farmers, people in the countryside, to have small private plots and to sell the produce of these private plots through what are essentially open and free markets in the cities. According to the Soviet statistics themselves, those private plots account for about 3 per cent of the arable land of the Soviet Union. But the fraction of the total agricultural output which is attributed to them is between a quarter and a third of the total agricultural output of the Soviet Union.

I say **advisedly** the fraction which is attributed to them, because I am not by any means sure that all of that proportion is produced on those private plots; it may well be that some is produced on the government farms that surround them, but then come through those private plots.

But it is an interesting example of the extent to which, in order to have some incentive and to have some success in feeding their people, they have to rely on private markets.

The use of private markets in Russia goes much beyond that. The most active and extensive market in the Soviet Union is the Black Market. If something goes wrong in your apartment with your electricity, you will naturally be unwilling to wait the six months that is required before a Russian civil servant comes around to fix it–and as a result an active private market in home repair has grown up. In fact, what determines which official jobs people want to get in the Soviet Union is in very large measure the Black Market opportunities that different jobs provide. If you can get a job driving a truck then it's worth your while taking that job even at a low rate of pay, because in the off-hours you can earn a good deal by using the truck.

I don't intend to deliver an extensive discourse about the Soviet Union. I am trying to get across the point that when we talk about the future of capitalism we are not talking about the future of market arrangements or of large aggregations of capital. There is no possibility whatsoever of the future proceeding without markets and without large aggregations of capital, without there being capitalist societies in that sense, regardless of their political and economic organization.

The question at issue is a very different one: to what extent is there a future for free, private enterprise capitalism? That is the key question and, when we talk about it, we have to be very clear as to exactly what we mean. Free enterprise capitalism is often interpreted as a system in which enterprises are free to do what they want. That is a fundamentally fallacious idea; it is not what free enterprise is about and it is not what is important for the preservation of freedom.

The *Wealth of Nations* was not, as it is now so often regarded, a plea for a status quo; it was in fact a revolutionary document. It was a document calling for a drastic change in circumstances. The situation of Britain and of the rest of the world at the end of the 18th century was very close indeed to the situation that all of our countries are approaching today, that is, a situation of extensive governmental control. Adam Smith's book was an attack on mercantilism; it was an attack on the principle that government should decide who could trade with whom, what products could be imported, what products could be exported, and all the other paraphernalia of the command economy. It was followed in the course of the next 70 years in Britain, in the

United States and elsewhere as well by a dismantling of the governmental interventions and controls of the mercantilist period.

The repeal of the corn laws in Britain in 1846, which meant the repeal of tariffs on the import of food products, was a major step that started Britain along the road to a free enterprise society, towards a *laissez-faire* society in which government had very little role to play in guiding the economy. Similarly in the United States in the 19th century, government had very little role to play.

What you really must mean by free enterprise is a system in which anybody is free to set up an enterprise. The important thing is not freedom for existing enterprises to combine with one another to keep out competitors. The important thing is freedom to compete: freedom for somebody else to come in and offer an alternative to what you are producing or for somebody else to come in and offer you an alternative product or alternative employment. When we talk about that kind of free enterprise capitalism then we are talking about freedom in general and as I have already indicated, the two are indissolubly linked. I know of no case, at any time, anywhere, in which there has been any exception to that rule.

In discussing the future of free enterprise capitalism it is well for us first to look at its past and at its present. The high tide of free enterprise capitalism was undoubtedly the 19th and early 20th century, a period which was more or less instituted by the industrial revolution in Britain whose birthdate in a certain important sense we passed a couple of weeks ago on March 9, 1976. This was the 200th anniversary of the publication of *The Wealth of Nations*, by Adam Smith which is in many ways the bible of a true free enterprise system. That date – 1776 – is a double bi-centenary. March 9 marks the birth of the free enterprise bible while July 4 marks the 200th anniversary of the political counterpart of a free enterprise society: the declaration of Independence of the United States. This was the beginning of a free political society in the United States, which was largely built in the following century or century and a half, along the lines set forth by Adam Smith in the “Wealth of Nations.”

If you want to look at a single number which will guide you along this line, you might ask what proportion of the total income of any community is spent on behalf of its citizens by government. At the time of Queen Victoria’s Jubilee in Britain, the time of Great Britain’s greatest power and influence over the world, total government spending in Britain, including central, provincial and municipal, amounted to roughly 10 per cent of the national income. In the United States during the 19th century, which was the period of the height of free enterprise and *laissez-faire* capitalism, total government spending – federal, state and local – amounted to less than 10 per cent of the national income. I shall return to that number later because it has changed somewhat since then.

That period is an era which the enemies of freedom have tried to denigrate as a time in which the masses were being exploited by the people of influence and economic power. In the standard writings of the modern proponents of Fabian Socialism, or in the United States of democratic liberalism, the malefactors of great wealth ground the poor, ordinary man under their heels. This is precisely the opposite of the truth. There is no century in history that can compare with the 19th and early 20th centuries in the extent to which the ordinary man reaped greater benefits, had a greater expansion of opportunities open to him or was able more effectively to establish a situation under which his children and children's children could have a better opportunity in life.

In Great Britain, where the *Wealth of Nations* made its first impact, where the industrial revolution occurred, where *laissez-faire* has its home-land, the ordinary working man had an enormous increase in his well-being. The average level of living went up sharply in the United States. It was a period when millions of impoverished people from all over the world came in as immigrants with empty hands, bringing nothing in the way of possessions.

Decade after decade the conditions of the ordinary man improved. His opportunities broadened. He was able to establish a base for himself and for his children. I speak feelingly, because I, myself, am a product of that process. I, and millions of my fellow citizens in the United States, would not now be able to have the amenities we have, or the possibilities and opportunities we have, if it had not been possible for our parents and our parents' parents to leave countries in Europe in which their conditions were very disadvantaged and make their way to the United States. They progressed in that country, not despite, but solely as a result, of the absence of government controls and intervention and the existence, therefore, of an essentially free society.

Even in an area which is generally ignored, that of eleemosynary activity, the 19th century is a period without parallel. Consider the great private institutions that arose during that period including, for example, the private universities. My own university, the University of Chicago, is a private university, Yale, Princeton and so on, were all founded as a result of private benefactions. It was a period in which we developed a system of non-profit, non-proprietary hospitals to serve the medical needs of people around the country. It was a period of the Carnegie Libraries, of foreign missions, of the establishment of the Society for the Prevention of Cruelty to Animals and other similar movements too numerous to mention.

There is almost no period that I know which there was an equal outburst of activities directed to help the fellow man, the reason is that free enterprise has a role to play in private eleemosynary activities no less than it does in the strictly industrial and economic activities.

You South Africans are yourselves the beneficiaries of the process whereby free enterprise *laissez-faire* in the 19th century made it possible for the underdeveloped countries of the world to emerge. It was not through any government foreign aid programmes, or their equivalent, that any part of Africa developed, including South Africa, or other regions of the world. If Japan is today a great nation it is because in the 19th century, when Japan had its major restoration in 1867, it both took for granted and was forced to adopt a *laissez-faire* policy. Its growth in the next 30 years came entirely in a free trade world, in which it had no tariffs, no restrictions on imports or on exports and in which it was forced to compete with the rest of the world. No matter where you look in that period, the evidence is clear that the private enterprise, capitalist system promoted well-being and released productive power of a kind that has never been seen before.

Indeed, the most eloquent paean of praise that I know of for the private enterprise system is contained in the *Communist Manifesto* by Marx and Engels published in 1848, in which they say that, in all of human history, nothing has released so much productive power as the capitalist system.

And what was true of the 19th century is no less true today. The same effectiveness of free enterprise capitalism in promoting the conditions of the ordinary people shows up today. You have, for example, the large country of Red China and next to it the tiny island of Hong Kong. Which one of these two countries has to police its borders to keep residents from other countries from trying to get in? It is not Red China. You have East Germany and West Germany – two people separated by the accidents of war and providing an almost perfectly controlled experiment for scientific purposes: people of the same heritage, the same technical skill and the same industrial background. Which one of those two countries had to build a wall to keep its citizens from trying to get out? On the one side of that wall you have misery and indigence. On the other side of that wall you have affluence and prosperity. What is true of those countries is true wherever you look. Compare Taiwan and Japan, on the one hand, with Red China on the other, or compare Singapore with Indonesia. Whatever comparisons you make, you will find that where free enterprise has been allowed to stretch its muscles, where it has been allowed to operate, you have both an improvement in the well-being of ordinary people and a large measure of political freedom.

But along about the end of the 19th century there began an intellectual drift away from this system. The belief in individualism declined and a belief in collectivism emerged. Just as the process towards freedom had started in Britain with Adam Smith's *Wealth of Nations* so the movement away from freedom started also in Britain at the end of the 19th century, fundamentally with the rise of the Fabian Socialist movement. The earlier *Communist Manifesto* had an enormous influence in socialist states around the world. But, from the point of view of the world that was free, the Western world, it was not Marx or *Das Kapital*, that was the source of change in public attitudes; it was rather the move towards collectivism which, in the British case, took the form of Fabian Socialism and which spread from Britain to the rest of the Western world. The great English constitutional lawyer, A. V. Dicey, gave a series of lectures in 1899 at Harvard University, under the title of "Law and Public Opinion in the 19th Century." He re-published those lectures in 1913 with a new preface, and in that preface he already foretold the direction in which Britain was to go because it was already clear by that time, Britain had started to shift away from an individualist, free enterprise society, towards a collectivist society. The term, "the welfare state," had not been coined and he did not use it; but in that preface he is essentially setting forth the future effects of this loss of reliance on individualism and the tendency towards collectivism.

In the United States the intellectual movement towards the welfare state was a little later in getting under way, and was longer in making itself felt. Fortunately the United States is a more diversified country than the United Kingdom. The United Kingdom is a much more structured society and has a more homogeneous group of leaders and it can therefore move more rapidly in a good or in a bad direction. The United States is a much more heterogeneous, diversified, widespread society and it therefore takes us longer to do good, but by the same token it takes us longer to do the wrong things. Thus we have been somewhat slower in moving in the same direction.

The key event in the United States was undoubtedly the Great Depression which crystallized the intellectual movement, and caused it to have its effects in action which in turn caused a widespread change in attitudes about the role of government away from the earlier view that government was to serve as an umpire towards the modern view that government is to serve as the Big Brother. That Great Depression itself helped to crystallize this change, because of the misinterpretation of its origin and sources. It was said that the capitalist system was fundamentally unstable and that private enterprise produced the Great Depression and the government, of course, had to step in, in order to bail society out.

Once again the facts are the opposite of the myth: the Great Depression was a result of bad government policy, not of a failure of private enterprise. In the United States the Great Depression was produced by the mis-management of the monetary system by the Federal Reserve System. The Great Depression, in its worst manifestations throughout the world, had its origins in the United States, and spread from there to other countries. If you trace its origins in the United States, you will find that it developed from a failure of the Federal Reserve System to act in accordance with the objective that had been set for it when it was founded in 1914 to prevent monetary crises and panics.

In the event it permitted the total quantity of money in the United States to decline by a third from 1929 to 1933. It produced a banking panic in early 1933 that was vastly more severe, more extensive and more destructive than anything that had happened before World War One. Indeed, in a book that I and Anne Schwartz wrote some years back on the monetary history of the United States we argued, and I believe provided persuasive evidence, that if the Federal Reserve System had never been established in 1914 the United States and the world would never have experienced the Great Depression. But yet the fault was attributed to free enterprise. If anything goes wrong in the world, you can be sure that the government will say: “It’s not our fault. Don’t blame us.”

In the United States and in the most of the rest of the world, the two greatest enemies of the free enterprise system have been my fellow intellectuals, on the one hand, and you and your fellow businessmen on the other – for opposite reasons. My fellow intellectuals are all in favour of freedom for themselves, they want freedom to speak, to write and to do research as they wish. The idea of establishing a central planning board which would decide what projects should be researched, and select the appropriate project in accordance with social priorities and grant it to the individual who is best qualified to do it would cause them to throw up their hands in horror – and quite rightly. But when my fellow intellectuals come to look at the economic world they look at it very differently. Then they say: “You can’t afford those wastes of competition. You have to rationalize and organize things. You have to put us in charge to tell them what to do.” So my fellow intellectuals are in favour of freedom for themselves – but not for anybody else.

The businessman is very different. He is always in favour of freedom for everybody else. If I ask a businessman whether we ought to have free competition, provided I talk about some industry other than that in which he is engaged, he is all in favour of it. But if I meet a businessman in, for example, the textile industry, he will tell me: “Of course, we need a tariff, of course we need to have the government give us special tax privileges,” and so on. If I talk to somebody in the business of producing agricultural products in the United States he will want quotas. I understand that, even in such a free enterprise place as South Africa, people who produce grapes have to have quotas, at least if they are going to sell them for wine, instead of just for the grapes of wrath! The businessman is always in favour of freedom for everybody else but he always wants special treatment for himself.

As the intellectual tide has shifted away from a belief in individualism towards collectivism, practice has shifted in the same direction propelled by the co-operation of these two most unlikely bed-fellows, the intellectuals, do-good reformers, on the one hand and the supposedly hard-headed businessman on the other. Together they are driving society towards an end which, if achieved, neither will be able to live with. In the United States consider the oldest example of widespread government interference, the Interstate Commerce Commission, a governmental commission that was established in the 1880's to control the railroad industries. The movement towards it was started by reformers who thought the railroads **in** the United States were monopolies who were exploiting their customers, and that we should have a governmental commission in order to make sure that the railroad fares were held down and were fair and competitive.

When this idea was broached, some of the people in the railroad industry thought that it had some merit as the industry had been trying for years to have price fixing agreements. The problem was that no sooner would they get a price fixing agreement established, then some chiseler would deviate from the agreement and it would come crashing down.

So, quietly, not letting anybody know they were involved, some of the central figures in the railroad industry got behind the Interstate Commerce Commission which was soon dominated by the railroads and worked very well as a device for keeping fares up and preventing competition from lowering them. And that has been the experience of every single commission from that day to this.

Of course, the same course of events is not unknown in South Africa. A former professor at the University of Cape Town, W. H. Hutt, wrote a book a few years ago called *The Economics of the Colour Bar* in which he pointed out that the policy of apartheid in South Africa had its origin in trade union insistence on equal pay for equal work. If there is going to be equal pay for equal work, then there are going to be segregated jobs. We have the same problem in the United States. We have our poor, misguided women labourers saying: "We have to have governmental laws to make sure that there is equal pay for men and women in the same job." They do not realize it is anti-feminist legislation because if they insist that by law you have equal pay for equal work they are going to end up having reduced employment opportunities for women in jobs in which, for one reason or another, the males have an advantage, whether that reason be irrational prejudice or valid differentiation.

No man who looks coldly at the facts can deny that there has been a vast reduction in the extent of free enterprise capitalism both geographically and within individual countries. The United States is today the major bastion of free enterprise that remains, certainly on any large scale, and even we have retreated very far down the line.

In the purely economic area, our freedoms have been restricted to set up enterprises such as banks, television stations or taxi cab companies. But of course, the retreat from a free society has gone on in all areas. I mentioned earlier that, in the 19th century, government spending in the United States was about 10 percent of the national income. In the 40 years since the 1930's that fraction has risen until it is now 40 per cent of the national income. That means that every man, woman and child in the United States works, on the average, 40 per cent of the year in order to provide income for government to spend on his behalf. We have, of course, voted for this through a democratic process. And yet, what we have voted for is a restriction on our individual freedom to use our resources as we see fit for our purposes.

The 40 per cent figure grossly understates the extent to which government controls our activities. Many restrictions do not involve any expenditure: the fact that I have to get permits to engage in certain activities for example, does not involve much government expenditure. There are many other restrictions that do not show up in government expenditures.

Freedom in the economic sphere has had an impact on our political freedom and our freedom in a most fundamental sense: our freedom of speech. Few businessmen in the United States today feel free to express their views openly in the public forum, and I do not blame them. There are exceptions, but the businessman will surely think twice about coming out openly in opposition to government policies when he knows that one result may be a tax man on his doorstep the next day. Another possibility may be the threat of an anti-trust suit, or the loss of a lucrative government contract. I have been impressed in the United States by the extent to which the level of public discussion of public issue by the business community has been at a very much more decorous, polite and non-controversial level than it was 50 years ago. There are some exceptions but they are few and far between. This trend affects not only the businessman.

I find it very hard to believe, for example, a medical professor, whose research is being supported by our national institutes of health, will not think twice or three times before he comes out with a public polemic against socialized medicine. In fact, I have sometimes said that perhaps the only people in the United States who have effective freedom of speech are that small number of people who are in my fortunate position: tenured professors at major private universities on the verge of retirement.

And yet I do not want to give a false impression: America today remains a predominantly free society.

We are certainly a more prosperous society than others not because of government intervention, but despite it. We are more prosperous because we have been able to build on the foundations laid in the 19th century. If in the 19th century there had been as much government intervention and control in the United States as there is now, the United States would be an underdeveloped country, but today we have the great benefit of our inheritance, and we are a rich and wealthy country which can afford a lot of ruin. After the United States won the battle of Yorktown, the final victory over Britain in the Revolution, a young man came to Adam Smith and bemoaned the loss, saying that it was going to be the ruin of the British nation. Said Adam Smith: “Young man there’s a deal of ruin in a nation” and that is a very wise thought.

The United States is rich, we can stand a lot of ruin. We have strong traditions and, above all, to preserve our freedom, fortunately, we have a most inefficient government! You must not suppose that that is simply a humorous comment. The greatest defence of human freedom is, without question, the inefficiency of government. If there are elements of freedom left in the Soviet Union it is because of the inefficiency of the government.

In the United States, fortunately, most of that 40 per cent which is being spent by government is being wasted and therefore not doing the amount of harm it could. A great teacher of mine, Harold Hoteling, a great mathematical statistician, once wrote an article on the teaching of statistics in which he said: “Pedagogical ability is a vice rather than a virtue if it is devoted to teaching error.” Now efficiency is a vice if it is devoted to doing the wrong thing. If the government is engaging in wage and price control – the more efficient it is the worse it is for the country, whereas the less efficient it is, the less harm it does.

In general, we have as much freedom as we do because so much of our governmental expenditure is wasteful, and because our citizens are so adept and so ingenious at finding ways to get around governmental regulations.

There is no doubt, however, that, not only in the United States, but throughout the world, the area of freedom is contracting. In the United Kingdom today, 60 per cent of the national income is being spent by the government and the United Kingdom is very near to the tipping point where it may lose its freedom within the next decade unless there is a drastic change. But we have come to something of a turning point, I think, in the state of the world. If you were to extrapolate past trends you would have to conclude that the days of freedom are over and that the world is heading towards totalitarianism. Happily, you cannot extrapolate past trends. They cannot continue. For example, the fraction of the national income spent by government in the United States went from ten to 40 per cent in the past 40 years. I assure you it will not go from 40 to 60 per cent in the next 40 years! And we are coming, I think, in many countries, and particularly I feel strongly in the United States, to a turning point where there is a possibility that the trends will be reversed. As government spending is expanded and as government controls are expanded we have shifted from the situation in which small taxes are being imposed on many people to give concentrated benefits to a few, to a situation in which all of us are reaching into our right hand pocket to put something into our left hand pocket and in which the public at large has been getting wiser about the possibilities of governmental action.

There is no doubt that the citizens in the United States, even many of its intellectuals, have been largely disillusioned about the extent to which you can solve social or economic problems simply by turning them over to the government. We have had a wonderful lesson, in my opinion, which bodes very well for the future, in the experience of New York City, the most welfare-state and socialist-oriented city in the United States. Fortunately unlike the United Kingdom, unlike Washington, unlike South Africa, New York City does not have the printing press on which it can turn out those pieces of paper we call money. As a result, it was unable to bail itself out by going in for a high rate of inflation and it therefore had no choice but to face up to its difficulties. The fact that in New York City, it became patently obvious that the result of government spending had been to make matters worse for the ordinary people brought home sharply to the American people that the end process of this development is financial chaos and loss of freedom. The citizens of New York City no longer have a vote in their destiny. Because of their financial crisis there is now a caretaker group appointed by the State of New York to run New York City.

The example of New York City had a great impact on the people of the United States There is a widening recognition on their part, and the part of people throughout the world, that government is not a very efficient mechanism for achieving good results In addition, everywhere the public at large is getting fed up with the high rates of inflation that have been one of the consequences of the attempts by government to spend more, yet appear to tax less. Consequently, there are important forces at work which offer the possibility of bringing an end to the trend that we have been experiencing.

It is very far from being a sure thing. On the contrary, unless we turn in the very near future it is doubtful that we will have the opportunity to turn at all.

But I believe that there is still time, still hope and still possibility. All of us all over the world should ponder that possibility and do what we can to encourage a movement away from greater reliance on governmental authorities and a movement toward greater reliance on individual enterprise and initiative.

Notes

* An address to 200 Durban Businessmen, 29 March 1976.

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"The Fragility of Freedom"*

by Milton Friedman

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I am going to talk about freedom today primarily in terms of the United States. Unfortunately I have so far been in South Africa only two days and long experience has demonstrated to me that you have to be in a country three days to become an expert. Of course, if you stay beyond three days you discover that your expertise has disappeared.

We in the United States, and many of you in this country, who have been fortunate enough to be born in a society with a large measure of freedom, tend to take freedom for granted and to regard it as the natural state of mankind. This is a little less so for people in countries like South Africa than it is for people in the United States, Great Britain and other Western countries, and I speak therefore mainly from the standpoint of my own country. We take freedom for granted. The fact is, however, that the natural state of mankind is not freedom but tyranny and misery. A minority of the world has historically enjoyed freedom and that area of freedom has been declining and not growing. It consists today only of Western Europe, the United States, and a few former European colonies such as Australia and Canada.

The fragility of freedom from this aspect was brought home to me very forcefully about a year ago when I spent six days in Chile. Chile is a small country but it is a country whose experience is very pertinent and teaches a very important lesson about the fragility of freedom. Of all the countries in South America, Chile has probably the longest history of a relatively free and democratic society. Now there are some interesting parallels between Chile and other societies with historical backgrounds of freedom and democracy such as Great Britain and the United States. The emergence, for example, of the welfare state began in Chile at about the same time and in roughly the same way as it did in the United Kingdom – in the first decade of this century.

In Chile the State grew inexorably and ultimately reached a level of spending that came to be so large that it was impossible to finance it without producing substantial inflation. The Government incessantly spread its influence giving rise eventually to the Allende regime, which threatened to bring about totalitarian rule of the left. The subsequent economic and social chaos led to a military takeover by the Junta which now governs Chile. Chile is no longer a relatively free country. It is now a country which is ruled by the armed forces and in which individual freedom is far more restricted than it was before.

The downfall of freedom in Chile did not arise because evil people tried to do evil. The downfall of freedom in Chile arose from good people trying to do good, but trying to do good in the wrong way, that is, with other people's money. The welfare state derives from generous impulses but the consequences as it develops are bad and ultimately include the destruction of freedom.

If you try to do good with somebody else's money you have to get the money with which to do good and that means you have to take it away from other people. The welfare state thus has extortion and coercion at its very centre, because in order to do good the welfare state must use force to take people's money away from them.

Nobody spends somebody else's money as carefully as he spends his own. The result is that in practice, when you try to do good with other people's money, then you do not do good, you simply waste the money. Once there is money to be obtained, many people other than those whom the state intended to help in the first place will make a bee-line for the money and demand a piece of it. The end result is a proliferation of welfare state measures which do not achieve the initial objectives. Their initial well-meaning proponents are frustrated, and demand still more measures of this kind, which ultimately cause the breakdown of a free society.

At the beginning, the process usually goes rather smartly because the state is imposing small amounts of taxes on large numbers of people to render concentrated benefits to a small number of people. As time passes, the number of people on whom the state is trying to bestow benefits becomes larger and larger, while the number from whom it can extract taxes does not grow, with the result that a situation arises in which half the people are trying to extract funds from the other half. Because Chile is a poor country, the breaking point came as a result of government spending about 40 per cent of the national income. At that point the amount that could in fact be extracted in taxes was about 30 per cent of the national income, so the balance had to be financed by printing money and Chile entered into a violent inflation. At the end of the Allende regime inflation was raging at the rate of something like 800 per cent a year. When I was down there a year ago the inflation was running at 20 per cent a month. It has now been reduced to single digit figures – per month – not per year. That is a situation in which it is almost impossible to maintain a free and democratic society.

It may be suggested that I have chosen a bad example in Chile which is a poor, backward country in a region that is not renowned for its political freedom and liberty. Let me try an example that would be more meaningful to you. Consider the United Kingdom, a nation which has been following precisely the same direction as Chile and, I fear, could be headed for a similar fate. The United Kingdom, too, started down the welfare state road with an expansion in the role of government in the 1900's. It again proceeded smoothly to begin with as the state could impose taxes on a large number of people to benefit a smaller group. But today government spending in the United Kingdom has reached 60 per cent of the national income. The effect of welfare state policies and of the expansion of government has been to undermine the political stability and economic strength of Great Britain, creating the classic division between the recipients of government funds and the people who pay the taxes.

The results of this process in Great Britain have been an undermining of the productive potentiality of the country to the extraordinary extent that, whereas before World War II, in 1939, the average income in real terms per person in Britain was double that of Germany or France, today the average income per person in Germany or France is double that of Britain, an almost incredible reversal.

The motive was to help the people; the objectives were fine, but we all know that there is a very famous road which is paved with good intentions. We have to look, not at the motives, but at the result. The motives were to produce equality and well-being. The result has been to maintain inequality and to produce distress and a very low, although widely shared, standard of living. I do not know where Britain is going to end up. She is now in a severe economic crisis and it may be that the outcome will be similar to that suffered by Chile: the destruction of freedom, of a democratic government, the resort to some type of a dictatorship. Of course it will be a peculiarly British type of dictatorship: they will be polite but in any dictatorship or any control by armed might, the iron fist will be inside the velvet glove. I hope I am wrong. After all, it is hard even to utter the words I am uttering. We have all of us been brought up on the great tradition of English freedom and respect for personal liberty. We in the United States derive our institutions and our respect for civil liberty from the British example. Countries around the world which have been able to maintain a free society derive from Great Britain more than they derive from any other source. That is why it is so peculiarly tragic to see the possibility, even in Great Britain, of the destruction of freedom and the emergence of a collectivist, totalitarian state. I hope that does not happen but it is very hard to see any other outcome of the course on which Great Britain is proceeding.

I now give you, from my own country, that great city of New York. New York is the most welfare state oriented city in the United States. It has proceeded along the same lines as Chile and the United Kingdom. There is one very important difference: fortunately, unlike Chile or the United Kingdom, New York does not have a printing press from which it can turn out pieces of paper that people can regard as money. As a result, the parlous state of the financial coffers of New York has come to surface earlier than it otherwise would. If New York were a sovereign state, with its own currency, you can be sure that by now you would have seen the emergence of rampant inflation as a result of the printing of money to finance the deficit. But fortunately New York cannot do that and so the crisis has emerged rather as the potential bankruptcy of the city with its assets less than its liabilities.

New York is again a marvelous example of how good intentions can lead one astray, of how trying to do good can lead to harm. About six or seven years ago, my distinguished colleague, John Kenneth Galbraith, wrote an article on the problems of New York in which he said: “There is no problem that New York City has which could not be resolved by the doubling of New York City’s budget.” In the interim the budget of New York City has quadrupled, and the problem, instead of being solved, has become worse. New York has taken money from the hands of people who will spend it carefully and put it into the hands of people who will spend it carelessly and as a result the problems have multiplied.

Having cited these examples, let us now seek the explanation. Why is it that the attempt to do good leads to these adverse results? I have already emphasized that the major defect is the attempt to do good with somebody else’s money but on a more fundamental level you have to look at the difference between the political market as a way of arranging things and the economic market as a way of arranging things. What we call a political system is really a market system, except matters are determined by voting instead of by buying and selling. The politicians secure their positions by selling programmes and buying votes in what is essentially a market arrangement.

In considering the difference between the political market and the economic market, and considering why it is that the economic market provides a greater degree of freedom than the political market, please put to one side, right away, a distinction that is often made but that is utterly false. In discussing an economic market we are inclined to say that people pursue their own interests, the essence of an economic market being self-interest. When we talk of a political market, we talk of public servants and this suggests that they are serving the public. That is an utterly false distinction. We are human beings and we all pursue our own interests. A government civil servant is pursuing his own interest no less than an employee in a private enterprise. The distinction between the political market and the economic market is not that in one case you have people pursuing their self-interest and in the other case you have people pursuing the public interest. The difference lies in what different individuals perceive their self-interest to be.

Another myth about the political market, a myth of which you people in South Africa are particularly aware, concerns the belief that somehow it provides one person with one vote. We have a democracy in the United States in that every person gets a vote but that does not mean that every person has an equal power to effect the outcome. Although the form may be one person, one vote, the fact is that it is a system of highly weighted voting. The United States is a country run by the majority, that is true, and yet people are always complaining about all the special interest legislation which we have. We have legislation which benefits the ship building industries which receive subsidies, and special legislation for the aircraft industry. We have special legislation to provide loopholes in the tax system, and so on.

A political system, in which you decide by a vote, is a system of highly-weighted voting in which special interests have far greater roles to play than does the general interest. It is again the natural tendency to say that mean and wicked people by some devious device are able to manipulate the Congress and get their way. It has nothing to do with mean and devious people. It has to do with the fact, rather, that in a political market decisions are made by a yes/no vote. As a result, concentrated interest has a far greater influence than general interest.

Let me illustrate that in a very simple way. We have a special programme in the United States whereby the Federal Government pays the salaries of people who taste tea, which is imported from abroad and graded. About five years ago the then President Nixon tried to get rid of this tea-tasting subsidy. He said, quite properly, that if the tea industry wants to grade tea, let them hire their own tasters. Why should the taxpayers in general pay for it? The tea industry immediately launched a vigorous campaign and the result was that we did not get rid of the tea-tasting subsidy. That is typical and demonstrates that the strongest group in a supposed democracy is not a majority but a small minority which wants something very much which has a very small effect on the rest of the country. A small group to whom some governmental action or other is going to be worth a million dollars will work very hard to try to get that through Congress, contributing to campaign funds and so on. To the ordinary citizen, it might mean 10 cents a year and it is not worth his while to investigate.

People are always complaining that voters are ill-informed. Of course voters are ill-informed. It doesn’t pay them to be well informed. Why should I spend many hours of my time to learn about something that is going to cost me ten cents a year? It makes no sense. As a result the essence of a political market is that concentrated interest will dominate the diffuse public interest. There is nobody in a political market who speaks for the public interest. The way to get elected is to find an item of interest to, say, 5 per cent of the voters and having little significance of the rest. The 5 per cent will be willing to give you their vote if you support that particular item regardless of what else you do. You’ve got that locked up. Then you get another 5 per cent and then another 5 per cent, and eventually you put together a majority which consists of a coalition of special interests.

There are some decisions which have to be decided by a yes/no vote. There is no way in which the United States, for example, can simultaneously be at war and not at war. Decisions of that kind have to be decided by a yes/no vote, and that is the appropriate role of the political mechanism. But the great mistake, in my opinion, has been the movement of the past 50 years in the United States, and in other countries, toward a greater and greater reliance on this simple mechanism. Today's great mistake is to use the yes/no system for items that do not have to be decided by a majority vote, rather than to leave each person to decide separately.

Consider, by contrast with this, the characteristic of the economic market, where voting is by dollars. It also is a system of unequal voting with one dollar worth one vote, because some people have more dollars than other people; but it is no more unequal than one man one vote, in the political system, where, as I have shown, you also have unequal voting; and the great virtue of the economic method of voting is that each person gets what he votes for.

Let us take a very trivial and foolish example: that the question is what colour of tie should people wear? If we decide it by a political vote and 51 per cent of the people vote for a red tie and 49 per cent of the people vote for a green tie, then 100 per cent of the people will get a red tie. By contrast, if we all go down to the stores and shop, if 51 per cent of the people want a red tie, and 49 per cent of the people want a green tie, 51 per cent of the people get a red tie, and 49 per cent of the people get a green one. The beauty of the market is that it is a system of effective, proportional representation. It is a system under which everybody gets what he votes for. The great defect of the political system is that there is very little relationship between what you vote for and what you get. In the first place, the minority is effectively disenfranchised. If 51 per cent of the people go one way, and 49 per cent go another, the latter don't get what they want. There is another sense in which voters, having voted, do not get what they want because the government they have elected may turn out to be something completely different from that for which they thought they were voting.

When you vote at the market place you vote for everything separately. You can have what you want in the way of food or clothing, or whatever particular item you vote for. Moreover, nobody gets money from you except with your consent. If you buy something it is because you feel you are getting a good buy for your money. There is a rand for rand relationship between what you spend and what you get and, therefore, you have the right interest and the right incentive to spend your money wisely whereas, in the voting booth, there is little relationship between how much it costs you and how much you get from your voting and this provides little incentive to vote intelligently.

While the essence of the political arrangement is coercion and force, the essence of the market arrangement is voluntary co-operation between people. It seems to me that perhaps the greatest obstacle in the way of effective development towards a harmonious multi-racial society in South Africa is the fact that your government exercises so much control over economic matters. Human freedom cannot be combined with centralized governmental control. The great virtue of a private, free market, is that everybody is at liberty to deal with whomever he wishes and on the terms that he wishes. This is the reason why the development of a free market in the 19th century saw the greatest expansion of human freedom the world had ever seen. Unfortunately, the world has been moving away from these great principles. In the United States, 50 years ago, in 1929, total government spending amounted to 10 per cent of the national income and most of that was local with the federal government in Washington spending only three per cent of the national income. Today, total government spending is 40 per cent of the national income, and Washington alone is spending about 25 per cent of the national income – almost 10 times as large a proportion as it was spending 50 years ago.

The result has been a drastic restriction in economic, personal and political freedom, and unfortunately this has been the trend in many countries around the world. I do not believe that trend is inevitable. It has been reversed before. It was reversed in Britain in the early 19th century. It can be reversed again. I have a considerable hope that it will be reversed in the United States. There is an increasing tide of disillusionment with what can be accomplished by government, an increasing drive for greater personal and human freedom and so I have some confidence that we shall reverse the trend in the United States. But unless we do reverse the trend, we shall not have a free society. There should be an 11th commandment added to the Bible's present ten, which I think might stand as the model for a free society. That commandment is: "Everyone shall be free to do good at his own expense."

Notes

* An address to 2,000 students and staff of the University of Cape Town, 22 March 1976. A similar address with the same title was given at Universidad Católica de Valparaiso, Chile, March 1975, and at Brigham Young University, 11 December 1975, and published in *Brigham Young University Studies* 16 (Summer 1976): 561-574.

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11/1/12

"Suicide of the West"*

by Milton Friedman

In *Milton Friedman in South Africa*, edited by Meyer Feldberg, Kate Jowell and Stephen Mulholland, pp. 58-60. Cape Town and Johannesburg: Graduate School of Business of the University of Cape Town and The Sunday Times, 1976.

Of the 49 countries in Africa, 15 are under direct military rule and 29 have one-party civilian governments. Only five have multi-party-political systems.

I have just returned from visiting two of these five – the Republic of South Africa and Rhodesia (the other three are Botswana, Gambia and Mauritius). If this way of putting it produces a double take, that is its purpose.

The actual situation in both South Africa and Rhodesia is very different from and very much more complex than the Black-White stereotypes presented by both the Government and the Press – and the situation in Rhodesia is very different from that in South Africa. Neither country is an ideal democracy – just as America is not. Both have serious racial problems – just as America has. Both can be justly criticized for not moving faster to eliminate discrimination – just as America can; but both provide a larger measure of freedom and affluence for all their residents – Black and White – than most other countries of Africa.

Both would be great prizes for the Russians – and US official policy appears well designed to assure that the Russians succeed in following up their victory in Angola through the use of Cuban troops by similar takeovers in Rhodesia and South Africa.

Rhodesia was opened up to the rest of the world less than a century ago by British pioneers. Since then Rhodesia has developed rapidly, primarily through its mineral production – gold, copper, chrome and other ores – and through highly productive agriculture. Both Whites and Africans have benefited from their co-operation. Modern cities, especially Salisbury, an extensive network of roads and communications, productive farm lands, mines and industrial works – all this would have been impossible for a population of Whites that even today totals fewer than 300,000.

On the other hand, without the knowledge, skill and capital provided by the Whites, Rhodesian Blacks would today be many fewer and far poorer. To judge from the crude evidence that is available, the Rhodesian Blacks in the modern sector enjoy an average income that is considerably more than twice as high as that of all the residents of the rest of Africa, excluding only South Africa.

The relation of the Whites to the Blacks is complex: a large dose of paternalism, social separation, discrimination in land ownership and little or no official discrimination in other respects. In particular, there is no evidence of that petty apartheid – separate post office entrances, toilets and the like – that was America's shame in the South and that I find so galling in South Africa.

The education of the Blacks has been proceeding by leaps and bounds. Today, half or more of the students at the University of Rhodesia are Black.

Guerrilla warfare from outside and inside the country has produced a reaction by the Government that can properly be described as repressive – but the provocation has clearly been great, and it is important to maintain a sense of proportion.

More than half the defense forces patrolling the borders are Black. I was told that more Blacks volunteer for the defense forces than can be accepted. The streets of Salisbury give a visual impression of a Black sea with occasional White faces that brings to life and gives new meaning to the 20-to-1 numerical population ratio.

It is very difficult to reconcile that visual impression with any widespread impression of feelings of oppression by the Blacks. If that existed, Rhodesia could not easily maintain such internal harmony or so prosperous an economy.

During the past ten years of sanctions, Rhodesia has grown in real terms more rapidly than in the prior ten years – and more rapidly than the rest of Africa. The external pressures against Rhodesia arise from its unwillingness to grant "majority rule" within a definite and brief timetable. Whatever the merits or demerits of "majority rule" as an abstract principle, the imposition of sanctions against Rhodesia on this ground is a striking example of a double standard.

The other former African colonies of Britain that were granted independence without question and without sanctions do not have anything approximating what Americans regard as majority rule. They have minority rule by a Black elite that controls the one party permitted to exist. If the elite minority in Rhodesia had happened to be Black instead of White, Britain would have rushed to grant them independence and provide "development assistance."

"Majority rule" for Rhodesia today is a euphemism for a Black-minority government, which would almost surely mean both the eviction or exodus of most of the Whites and also a drastically lower level of living and of opportunity for the masses of Black Rhodesians. That, at any event, has been the typical experience in Africa – most recently in Mozambique.

Rhodesia has a freer Press, a more democratic form of government, a greater sympathy with Western ideals than most if not all the states of Black Africa. Yet we play straight into the hands of our communist enemies by imposing sanctions on it.

The Minister of Justice of Rhodesia cannot get a visa to visit the US – yet we welcome the Ministers of the Gulag Archipelago with open arms.

James Burnham had the right phrase for it: suicide of the West.

Notes

* Some impressions of South Africa and Rhodesia – an article by Professor Friedman which appeared in *The Sunday Times*, May 2, 1976.

Excerpts printed in *University of Cape Town Graduate School of Business Journal*, 1975-1976, pp. 15-18.

11/1/12

"Has Gold Lost Its Monetary Role?"*

by Milton Friedman

In *Milton Friedman in South Africa*, edited by Meyer Feldberg, Kate Jowell and Stephen Mulholland, pp. 34-41. Cape Town and Johannesburg: Graduate School of Business of the University of Cape Town and The Sunday Times, 1976.

A real, honest-to-God gold standard has many advantages. If such a standard could exist, it would be one in which gold was literally money, and money literally gold, under which transactions would literally be made in terms either of the yellow metal itself, or of pieces of paper that were 100 per cent warehouse certificates for gold. Under a gold standard of that kind, or even a slight modification of it, governments would have very little leeway with respect to monetary policies they could adopt.

Under a system of that kind governments would have to accept the discipline of gold; they could not engage in irresponsible monetary policy and produce runaway inflation. Unfortunately, however, that kind of a real, honest-to-God gold standard has seldom, if ever, existed. The actual kinds of gold standards that have existed over the past two thousand or more years have been of a very different variety. Perhaps the closest approximation to a gold standard of this type was during the 19th century and early 20th century, in the period before World War I. That was a period during which governments were playing a small role in economic affairs. It was a period when government spending was low. At the time of Queen Victoria's Jubilee, when Great Britain was at the height of its economic and its political power, total government spending in Great Britain, both central and local, amounted to roughly 10 per cent of the national income.

In the United States at that time, and during the whole of the period of the 19th century except only in the period of the Civil War, government spending again amounted to less than 10 per cent of the national income. Governments were following a generally *laissez-faire* policy. Of the 10 per cent of the national income that was being spent by government in the United States, two-thirds was being spent by state and local government and only one-third by the federal government, so the total federal spending amounted to about 3 per cent of the national income. The only real interventions on the part of the federal government of any importance were tariffs and some measure of regulation over the national banking system. Under those circumstances, it was possible for governments to submit themselves to the discipline of the gold standard, to let their monetary policy be dictated by the necessities of the balance of payments.

But even under those circumstances, when on the whole gold played a very important and very healthy role, the gold standard was very far from the kind of panacea that has been painted by the more ardent advocates of gold. Over the past two thousand years, the use of specie, of metal, of silver or gold as money has not prevented, for most of the period, governments from depreciating the currency, from engaging in inflation as a means of extracting the income of the people for governmental purposes. In the early days of specie standards the methods were somewhat different. Before the invention of paper money the method by which governments depreciated their currencies was by mixing the precious metals with alloys of much less value. There is the famous example of the Roman Empire, which started out with its chief coin, the denarius, which was essentially a pure silver coin. By the time of Diocletian the historians of the coinage of the

Roman Empires were saying that the once proud denarius was little more than a copper coin with a thin wash of silver.

The 19th century was the best of these experiences because during that century we had relatively little of this kind of depreciation via the deterioration of the coinage. Yet, even during the 19th century, prices were very far from stable. For the period from 1800 to 1914, price indices reached a peak three times as high as their trough. Prices under a pure gold standard were thus far from stable, ranging over a scale of 3:1. Of course that is a lot better than the kind of ranges of 10, 20, 30, 40, 50 and even 1 000 and more, that have been experienced under some kinds of paper standards, and that is why I say that, on the whole, there are many advantages to a gold standard.

In addition to the fact that prices varied widely, the 19th century was not lacking in other economics disturbances. There were repeated economic recessions, banking panics and the like.

Whatever may have been true of the gold standard before 1914 the gold standard that emerged after World War I was a very different animal. This is not, I may say, a judgment that is peculiar to myself. While I have been here in South Africa, I have been reading a book on the history of the Oppenheimers and I ran across a quote from Sir Ernest Oppenheimer, in the early 1930's, in which he made the point more strongly than I can. He said, and I quote: "The gold system as it was before the war, and as it is now, is as different as chalk from cheese."

Now that was Sir Ernest Oppenheimer in the early 30's when he was campaigning in favour of South Africa going off the gold standard. And he was right in his view. The gold standard that emerged after World War I was much weaker than it had been before and it became even more so after 1934. It was much weaker because governments were becoming much different creatures. From being minor elements in the economy, with small budgets, and little intervention, governments were increasingly playing a major role in the economy and accepting greater and greater responsibility for the course of events.

We shifted from a real gold standard or, at least, an approximation to one, to a system that I have called a pseudo-gold standard, a fake gold standard, a system in which, instead of gold being money and thereby determining the policy of the country, gold was a commodity whose price was fixed by governments. Instead of allowing the inflows and outflows of gold to dominate domestic monetary policies it was domestic monetary policy that now determined what happened to the gold price and to gold inflows and outflows.

The demise of the gold standard was assured in 1933 when Franklin Roosevelt, as part of his policy after the Great Contraction, prohibited the private ownership of gold by citizens of the United States. From that point on, it was only a question of time until the gold standard was going to disappear from the world. There is no way in which the mythology of gold can be maintained if gold becomes simply something which is used by governmental agencies, central banks or monetary authorities, as a symbol of their policy. In order to retain its mythology, gold must be something which is used by private people in day-to-day transactions and which is held and owned by private people. It is only in countries like France, where private people have in fact been able to own or hold gold, where anything like the old mythology of gold has been able to keep its hold.

It is worth noting that the Great Contraction from 1929 to 1933 in the United States itself occurred under what was supposed to be a gold standard. Sir Ernest Oppenheimer was in favour of South Africa going off the gold standard so that South Africa could free itself from the depression that had originated in the United States and which had spread throughout the rest of the world via the existence of a gold standard.

The occurrence of the Great Contraction while we were supposedly on the gold standard is another example that the gold standard is not a panacea.

Let us return to the main lines of the story: First – President Roosevelt prohibited the ownership of gold and trading in gold by private individuals. Second – he raised the official price of gold to $35 an ounce.

It took a long time for gold to disappear from the market as a monetary medium but, thereafter, it was pre-ordained. Since 1933, the world has been going through a series of withdrawal pains from the attachment to gold. The question that you will ask, and the question that is asked over and over again is this: Given this historical development, is it possible to return to a real honest-to-God gold standard? The other night, at a talk in Durban, one of the gentlemen asked a very good question: "In the 1890's and the 1900's, governments played a very small role. There was discipline on government monetary authority, and it was because there was a real gold standard. Does that not mean that if we could only establish the real gold standard again, we could again have the disciplines of gold?"

The answer is that you have to put the horse before the cart and not the other way around. If you could re-establish a world in which governments budgets accounted for 10 per cent of the national income, in which *laissez-faire* reigned, in which governments did not interfere with economic activities and in which full employment policies had been relegated to the dustbin, in such a world you might be able to restore a real gold standard. But by trying to restore the symbol of a gold standard you are not going to restore the substance. In my opinion, there is next to no chance whatsoever that, under present circumstances, it will be feasible or possible or even desirable to re-establish a gold standard of the kind that prevailed in the 19th century. Indeed, few modern-day advocates of what they call a gold standard are in favour of restoring a **REAL** gold standard. The most vocal advocates of a supposed gold standard today are simply in favour of government price-fixing of gold at a higher price rather than at a lower price.

A real honest-to-God gold standard is not feasible because there is essentially no government in the world today that is willing to surrender control over its domestic monetary policy. No people in the world, in any of our major countries, including South Africa, is willing to exert its influence on the government in order to force the government to follow a gold standard policy, where it adapts its monetary policy to that end. And for that reason, in my opinion, there is essentially no chance of the re-emergence of a world gold standard.

What then is the future of gold?

The many years in which gold has been used as a monetary medium have left two heritages. One is the world-wide belief in gold as a store of value. That heritage makes for a demand for gold for private hoarding, which is very substantial and will last a long time and is not irrational in any way. Certainly there are circumstances in which gold may prove a useful store of value. For example, the Indians who were driven out of Uganda could not take with them their buildings or their homes because their government, like yours in South Africa, had exchange control, which meant they could not convert those assets into foreign currency. But if they had a couple of bars of gold, they probably could stick those in their pockets or suitcases and get out with them.

The other major heritage of the gold standard era is the enormous stock of gold which is held in governmental hands in central banks around the world. The total stock of gold in the central banks of the world amounts to something like 30 years of the world's annual production of gold. That stock of gold has the opposite effect of private hoarding on the future of gold. It is an overhang on the market that sooner or later will have to be disposed of because it serves no function for governments to tie up so large a volume of their assets in gold when gold is not playing a fundamental monetary role. While governments may protest, as France has protested, its willingness to acquire additional gold, I would suggest that you give more weight to what they do, than to what they say, and I shall be very surprised indeed if France is willing to add substantially to its hoard of gold.

As every country gets into difficulty at some time or other, the temptation for each will be strong to dispose of some of its gold as a means of financing its expenditures. Recent cases in point are the offering of gold as collateral for loans by Portugal, South Africa and Italy.

Ultimately, albeit in the distant future, the price of gold will reflect use for private hoarding and for private industrial purposes. But that time will only come when the overhang of gold has one way or another been worked off.

A valid question is this: If you view gold solely as a commodity, what is a reasonable price for it? One of the arguments that is made for gold as a store of value is that it is a hedge against inflation. Over the past fifty years, that has not been the case. Gold has not in fact proved a very good hedge. I once made the calculation that if somebody had bought gold in 1929, and had simply held it until today, paying something like 3 per cent per year for both carrying costs and loss of interest – after all a very modest allowance – he would today have something like a total purchasing power equal to about one-fifth of the amount he started out with. Anybody who held it only from 1929 to 1934 could have done pretty well, thanks to the U.S. rise in the price of gold to $35 an ounce. Anybody who held it from 1968 to 1974 would have done very well; but throughout the rest of that period anybody who held it continuously would have done very badly. Historically, gold has not proved a very effective hedge against inflation.

To return to the question: What current price of gold would correspond to earlier prices, allowing for inflation? That calculation is made very easily. The price of gold in 1929 was $20.67 an ounce. From 1929 to now, the price level has roughly tripled, so that the $20.67 of 1929 would today be above $60.00 an ounce. In 1934 Franklin Roosevelt raised the price to $35.00 an ounce and, because of the decline in prices during the Great Contraction, the price level today is roughly four times as high as the price level was in 1934, giving a current price of $140.00 as the outside upper limit of a price that could be justified by inflation. Both those limits are too high because, in 1929, half of the total world's output was being absorbed for monetary purposes whereas we are now talking of a future situation in which essentially none will be going into monetary reserves. In addition, there is no doubt that in 1934 the $35.00 an ounce was well above the true market price of gold because it produced an unprecedented flood of gold into the American coffers, a sure indication that the price was pegged above the market price.

I am not making any predictions about what is going to happen to the price of gold in the short run. I am only trying to look at the various factors entering into it and the plain fact of the matter is that, as of today, gold is a highly speculative commodity whose price may go anywhere depending upon speculation. If you want to get some time perspective about what the course of gold in the future is going to be, I think that it is useful to look back on the history of the other great monetary metal, silver.

Before the 19th century, silver was overwhelmingly the most important monetary metal. Gold was not the main money, silver was. Gold was too valuable to serve as money and, in fact, in many societies you had brass and copper serving as small change money, silver as the large change, and gold only for the super-large transactions.

The demonetization of silver took place largely in the 1870's when, for example, the U.S., after its Civil War experience of being on a floating exchange rate system, went back to gold in 1879, in a way that essentially demonetized silver which had served as its monetary standard before the Civil War.

In the 1870's the Latin Monetary Union, consisting mainly of France, Spain and Italy, shifted from a silver standard to a gold standard, and by the end of the century silver was essentially demonetized everywhere except for its usage as fractional coinage in which it was really circulating as a token currency rather than for the value of its specie content.

The monetary price of silver in the United States was $1.44 an ounce in 1879. By 1932, which is toward the close of the period during which the transition away from silver took place, the price of silver was 25 cents an ounce. In 1933, the United States made the great mistake of embarking on a silver purchase programme. It raised the price of silver at first to 70 cents an ounce, later higher, the effect of which was to complete the demonetization of silver.

By raising the price of silver, the United States drove China off the silver standard. It is an arguable proposition that one of the most important reasons why China is Communist today is that the United States Government in 1933/34, in order to get the votes of two Senators from Nevada, embarked on a silver purchase programme which raised the price of silver, drained silver from China forcing China into a deeper depression than it had ever experienced before and ultimately resulted in China going off the silver standard and onto a paper standard, which fostered the hyperinflation which was the final blow to Chiang Kai-shek.

From the point of view of our present story this rise in the price of silver in the 1930's was a temporary phenomenon.

It, too, produced a flood of silver into the U.S. coffers but then, as the price of silver was held down, as more world-wide inflation occurred, it became lower than the effective market price. Silver stocks were depleted but not until the 1950's was the process, begun 75 years earlier, of really demonetizing silver, completed. At that point, monetary stocks were more or less exhausted and the bulk of silver had gone into commercial and industrial use. Today, silver has risen back up again to $4.00 an ounce. The whole process took about 85 years.

The world proceeds faster today than it did then, so perhaps the process of demonetization of gold, and the distribution of the stocks of gold held by central banks, will proceed faster under present circumstances. This remains to be seen. I repeat that the one thing you have to keep in mind in looking at the future of gold is that it is a highly speculative commodity. It is a speculative commodity with two special features about it. The one is that there are two countries in the world which are the primary producers of gold, South Africa and Russia, and they will of course have a strong incentive to try to act in such a way as to hold up the price of gold. The other special feature is that there is an overhang in governmental stocks of 30 years' annual production, a substantial amount of which can at any time come pouring onto the market and cause a sharp decline in the price.

As a result, the prospect is that in the future, as in the past few years, the price of gold will fluctuate widely.

From the long run point of view, stability can only be expected when essentially the bulk of the output of gold can be used for industrial purposes, for jewelry and for private hoarding. Until that day comes, the course of the price of gold is very uncertain.

Notes

* An address to 300 Johannesburg businessmen, April 2, 1976.

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11/1/12

"The Milton Friedman View"

by Milton Friedman
In *Milton Friedman in South Africa*, edited by Meyer Feldberg, Kate Jowell and Stephen Mulholland, pp. 42-52. Cape Town and Johannesburg: Graduate School of Business of the University of Cape Town and The Sunday Times, 1976.

Professor Friedman's skill as a debater is legendary and he was given ample opportunity to demonstrate it to South African audiences. He held a series of seminars for staff and members of the MBA Programme at the GSB. He took questions after each of his formal dinner addresses and gave several press interviews. On the following pages, we publish a selection of his answers to very wide-ranging questions.

Government Development of the Infrastructure

From an MBA seminar at the Graduate School of Business, Cape Town, March 26, 1976.

You say private enterprise would not have undertaken certain "infrastructural developments." Is it clear that all of them should be undertaken? If it is not clear then what criterion are you to use to decide whether they should be undertaken? Electricity generating projects for example are perfectly capable of generating an economic return because they produce electricity that can be sold. But what are the externalities which justify other projects – to get back to the favourite way of evading hard issues? I'm not going to say that there are no projects which are ever justified by externalities. After all one of the duties my great and revered teacher, Adam Smith, assigned government was erecting and mounting certain public works and certain public institutions which it can never be for the interest of any individual or small number of individuals, to erect and maintain because the profit could never repay the expense to any individual or small number of individuals though it may frequently do much more than repay it to a great society.

He made exactly the same kind of exception that modern people do. But which projects are in that category? Why should a steel factory be governmental rather than private? Why should an oil project be governmental rather than private? Governments get capital from the people one way or another. A government's credit abroad might be better than the credit of some private people, but that aside, the capital available to government is also available to private enterprise.

Take our Western irrigation schemes in the United States. We spent at times $500 an acre to irrigate land that after it's irrigated is worth $100 an acre. I don't mean those exact numbers but that's the ratio over and over again. The worst case right now is the environmental legislation which required people who strip-mine to replace the contours of the land, even in areas where there are no people. Sometimes it costs a couple of thousand dollars an acre to redeem land which, after it is recovered, is worth perhaps $5 an acre. That's absolute insanity. If the value of recovered land rises to the point where it is worth the economic cost of recovering it, you can recover it at that time.

Most irrigation schemes such as those in underdeveloped countries are very hard to justify by cost benefit analysis. I know a good deal about India for instance where there was a tremendous waste of money on big irrigation dams when every indication was that you would get a lot more for the money if you drilled individual tube wells, for individual families. Now a high governmental official gets no great glory from cutting a ribbon on a tube well. And so the tendency in all of this “infrastructure problem” is to build monuments. All underdeveloped countries are the same. They all build the same monuments regardless of the circumstances. There is not one of them without its own steel mill. Every one has to have its own international airline. They all have their own domestically assembled cars which break apart on the road and so on.

Bribes, Watergate and Morals

From an MBA seminar at the Graduate School of Business, Cape Town, March 26, 1976.

We have just reconciled ourselves to the fact that we are not going to be the policemen of the world. Now the same people who have objected most strenuously to our being the policemen want us to be the moralists of the world. It’s absolutely absurd and I agree, masochistic. Whatever our own laws about bribes, it’s not in our national interest nor is it our right to set moral standards for other countries. So I have no sympathy whatsoever for this drive about bribes. I think we are doing ourselves enormous harm.

The Watergate business was a very complicated affair. The actions which Mr. Nixon and his associates took in covering up Watergate cannot be condoned, but at the same time they are not completely out of the range of historical precedent. The reason why Mr. Nixon was deposed had very little to do with the moral indignation at the acts which were undertaken. They had much more to do with the coming together of a number of forces which were strongly opposed to Mr. Nixon.

In the first place the news media reflected the animosity of the general intellectual community towards Mr. Nixon which dates back a long way, to things like the Alger Hiss case. Mr. Nixon also had the great unwisdom to threaten another group which then made common cause with the media – namely the civil service bureaucrats. Every country in the world is really run by its bureaucracy and Mr. Nixon became very aware of this. He inherited a bureaucracy that had been built up primarily under preceding Democratic administrations and that was out of sympathy with his general philosophy, so when he came into office for his second term he made up his mind that he was going to get some control of it. He asked a large number of top bureaucrats to submit undated resignations, that he could accept or not to his wish. Well I believe that this was a very fatal step. It’s not an accident that there was a sudden spurt of leaks from official sources that made their way into the news media. I believe that it was really the combination of these two groups plus, of course, Mr. Nixon’s own mistakes in handling the matter – the kind of arrogance that develops in anybody who is in a position of power for a long time – those three things combined ended up in the Watergate fiasco.

Personally I hold against Mr. Nixon the imposition of price and wage control far more than I hold anything that came under Watergate. He did far more harm to the country and to the things he really should have been standing for by that act than he did later on. But the consequences of the Watergate episode have been very adverse for the United States and for the world. Our constitutional structure did not have any place for a president being deposed except through either the termination of his period of office or the very rare impeachment. In fact Mr. Nixon was deposed by a branch of the government which is not recognized in the constitution – namely the news media. Once the news media has discovered its power that power will be used again. We have really had a fundamental change in our constitutional structure that is not for good.

So far as the world is concerned there is no doubt in my mind that if the Watergate incident had not arisen the political state of the world would be far healthier today. You would not have had Vietnam collapse as rapidly as it did. You would probably not have had the Yom Kippur war in the Middle East. You would certainly not have had Angola.

Two of these things happened during a year when the President was essentially immobilized and unable to conduct any effective foreign policy. And then you had his replacement by a new man whom the Soviet Union would have been stupid not to test, it's not clear that he passed the test with flying colours.

The extent to which the constitutional process was able to work, the extent to which we were able to get a change of President without any serious internal disturbance and so on, all speak very well for the toughness and reliability of our system. But taken as a whole we have paid a very very high price for it.

Exchange Control and the Rand

From an interview with Stephen Mulholland, Editor of the Business Times, published in the Sunday Times, March 28, 1976.

South Africa is threatened from abroad and you may say, you should have exchange control to prevent people from taking capital out. There are two answers to that. The first is that it won't work. People will find ways around it. The second and more important answer is that it is not sensible to make it work.

When you talk about people taking capital out of South Africa, what you mean is that somebody in South Africa sells his property to somebody else in South Africa, induces somebody else to buy the South African rands for dollars or pounds and then takes dollars or pounds out.

Now, let's see who is on each side of that transaction. The man who sells his property in South Africa is somebody who does not have great confidence in the future of South Africa. He is a weak man from your point of view. The man who buys the property in South Africa is somebody who has confidence in South Africa. Moreover, the man who sells will have to sell on terms that are unfavourable to him. The man who buys will buy on favourable terms.

Thus the net result of an attempt to move capital out of South Africa is:

(*a*) To transfer capital from weak hands to strong hands.

(*b*) To require those people who get their capital out to pay a price, both in the form of a lower selling price for their property and a lower price in foreign currency for their rand.

If you are successful in maintaining exchange control, the effect is simply to improve the conditions of those people who succeed in getting their capital out of South Africa. That is equivalent, if you want, to a subsidy to the exporters of capital because if they succeed in getting permission, they get their capital out at a favourable rate.

It has always passed my understanding why any government should regard that as a sensible policy to follow.

On currency the wise policy for a country like South Africa is to allow a free float, allow it to vary from day to day or month to month as the market demands. In that way you avoid having a period of apparent calm and then having a major disturbance such as occurs when you have a large devaluation.

The problem with a pegged rate is that it is subject to change from time to time. In every case in which it has ever been adopted, it has led to trouble. Under such a system, small disturbances, small disequilibria are permitted to accumulate into large ones. And then the Government or the Authorities are always very reluctant to make changes when needed.

They are always hoping that if they postpone them long enough the need will go away. Thus, they allow the discrepancies and the disequilibria to accumulate until a major change becomes necessary, which causes a substantial difficulty.

The Oil Embargo

From an MBA seminar at the Graduate School of Business, Cape Town, March 26, 1976.

The oil cartel will break pretty soon. Not in the next six months, but in the next year, two years, three years – that's the scale. It's showing signs of cracking at the seams now. If it weren't for the foolish domestic policies of the United States it probably would be closer to breaking. If the people who run our energy policy had been paid hirelings of the Saudi Arabians they could not have served their masters better. We have followed a very foolish policy by holding down the price of domestically produced oil and in effect giving a subsidy to foreign oil. Since the embargo in October, 1973 the fraction of American oil imported has gone up rather than down.

Even so, the quadrupling of the price of oil has stimulated efforts to reduce consumption and to find alternative means of supply, with the result that Saudi-Arabia and Kuwait are producing at something like fifty to sixty per cent of their capacity. They are holding the umbrella over most of the other countries in OPEC which are producing at something like eighty five per cent of capacity. It gets more and more difficult for Saudi-Arabia and Kuwait to do this as their production gets smaller as a percentage of the total, and one of these days the whole thing will break.

Some of the countries are held together by strong political considerations but not all. Iran is not an Arab country. Nigeria is not an Arab country. Venezuela is not an Arab country. One of these will break and oil prices will come tumbling down to a much lower level than they are at now. In a sense they already have. The price of oil today, if you allow for the world inflation in real terms, has come down about thirty per cent since October, 1973 when it was first quadrupled.

There have been all sorts of side deals whereby the price has been shaved a little here and a little there – many signs of cracking. I don't want to predict how soon the break will come because I think economists are worst at predicting the exact timing of things. In 1973 when it first started I did not expect the cartel to last as long as it has. It may last another year or two but I think its days are very narrowly numbered.

How Much Should Government Spend?

At the dinner in Johannesburg, April 2, 1976.

What percentage of national income do I think government should spend? There is no way to answer that question on the basis of theoretical considerations so I offer to you the empirical fact that at the height of the British empire, when it had more power both economically, politically and militarily than it has seen before or since, British government expenditure was 10 per cent of the national income. In the United States during its period of the greatest growth and prosperity, government spending for about a century was about 10 per cent of the national income. I've come to the conclusion that 10 per cent must be a pretty good number.

The Functions of Government

From an MBA seminar at the Graduate School of Business, Cape Town, March 24, 1976.

First to protect people and their property against coercion by fellow citizens – a straightforward police function. Second, to provide for the defence of the country against enemies from abroad. Third, to provide a means for deciding on the rules under which the market is going to operate. Property rights for instance are not natural – they have to be defined. And fourth, to provide a mechanism for adjudicating disputes among people over the interpretation of those rules. Those are the four primary functions which government should have. In addition, because any society contains some groups of people who are not responsible for themselves, in particular children and insane people, government has to play a paternalistic role in protecting their interests. I realize that potentially that opens the door to further government involvement, but I don't see any way to avoid it in this case.

The International Monetary Fund and Special Drawing Rights

From an interview with Stephen Mulholland, Editor of the Business Times, published in the Sunday Times, April 4, 1976.

I have long believed that the International Monetary Fund is a mistake. The world would have been better off if it had never been created and the world would be better off if it were abolished.

National central banks do harm within their countries; international central banks would do even more harm in the world at large if they were allowed to operate. Fortunately they are not.

The special drawing rights were also a mistake. They never should have been introduced and they are gradually sinking into a state of limbo. The whole justification for introducing them was linked to a world of fixed exchange rates. In a world of floating exchange rates SDR's have no use, certainly not as a component of international money. The SDR might continue as a unit of account but it is not going to be an effective and important part of the total volume of world purchasing power.

Blacks, Whites and Egalitarianism

At the dinner in Johannesburg, April 2, 1976.

The great discrepancy between the average income of the Whites and the Blacks in South Africa is at the root of your fundamental political difficulties with the rest of the world. Whether this discrepancy is just is not the issue. The issue is the perception of the rest of the world. And I believe South Africa will find it difficult to remain a stable society if it continues to have a discrepancy of ten-to-one between one sector of the society and another.

The pressures of the outside world, if nothing else, do not leave South Africa much alternative but to do something about it. How rapidly you can do it, whether you can succeed are questions which I am certainly not competent to judge, but I am enormously impressed that everybody I have talked to in South Africa has this problem at the top of his head.

I don’t think you should finance a programme as you suggest. That is the approach of the controlled society, not of the free society. The first thing you ought to do is to eliminate the barriers which you now impose on equal movements, on equal opportunity, for the various groups. A state cannot raise the income of anybody, but it can provide people with opportunities for developing themselves and using their own resources. No money is needed to eliminate many of the discriminations between your different groups.

Take the case of elementary schooling. Elementary schooling for Whites is free and elementary schooling for Blacks involves school fees and payments for books. Now, the natural tendency is to say, well let’s make it free for the Blacks as well. But surely the right way to go about it in the present circumstances is to impose identically the same fees on the Whites as you impose on the Blacks.

The problem is one of eliminating obstacles. I am not in favour of egalitarianism, in the sense of equal results. I see no merit in cutting down a tree in a forest that grows higher than the others in order to make them all equal. That is the egalitarian view. What you want to favour is the absence of the barriers, the absence of artificial impediments to the advancement of the individual in accordance with his capacity and ability. And for that you don’t need any finance. On the contrary, the elimination of many of the barriers which you now impose would release finance for other purposes.

Democracy

At the Johannesburg dinner, April 2, 1976.

The political mechanism is a very defective mechanism for expressing the will of the public. It is defective because the ordinary person has no incentive to inform himself about the consequences of measures that are taken. Small groups of people benefit very greatly from say, a tariff, a subsidy on farm products and other similar programmes. The special interest groups have an enormous incentive to get these programmes through commerce, through the legislature.

But here am I, an ordinary citizen. Any one of these programmes is going to cost me an extra 50 cents a year, and my vote is not going to make any difference anyway. When was the last time that anything like that was decided by one vote? As a result, although the form is majority rule, the reality is one of special interest rule.

The only way in which you can have a true democracy is through ordinances which limit the scope of the political mechanism to the area where it is not possible for each individual separately to go his own way – to matters which really have to be settled jointly. Then we should rely upon the market mechanism to co-ordinate the rest of the public's activities. It is paradoxical yet true that the market mechanism of voting enables people to achieve their own objectives more effectively than the mechanism of voting through a political process. And this is of course enormously important for countries like South Africa and my own. One of the beauties of the market mechanism is that it is colour blind. It enables people to co-operate together in their daily affairs regardless of whether they agree on political ideology, on religion or on other aspects of their life.

The basic problem with the political mechanism is that it requires too high a degree of conformism, which is very difficult to achieve without a very homogeneous population. Fundamentally, groups of people who differ very widely in custom and background can only live peacefully together in a *laissez-faire* world.

South Africa's Money Supply

From an interview with Stephen Mulholland, Editor of the Business Times, published in the Sunday Times, April 4, 1976.

The actual rate of growth of the money supply which would allow stable real growth depends on the characteristics of particular countries. For example, I have done some work for Japan and for Japan the right number is not three to five per cent as it is in the United States. It is something like ten to fifteen per cent a year, because of the different technological and economic characteristics of Japan compared to the United States.

I do not know what it is for South Africa, but I gather that real output in South Africa has been rising at the annual rate of about five per cent per year for a long time. What I would like to know about South Africa is what has been happening to money propensities in general. Talking from the experience of other countries, if you have a country, that is in a relatively early state of development which applies not to the White part of South Africa but to the rest of the country – you find that, as in Japan, the desire to hold money rises sharply with economic development, as the money economy spreads.

In general, in a country in a stage of rapid development, for every one per cent increase in real output, it takes about a two per cent increase in the quantity of money to keep prices stable.

Now that's the rule that happens to apply in Japan. If South Africa is still in that state of development it could mean for example, that something like eight to ten per cent might be the right numbers for South Africa.

But a steady rate of monetary growth is not a guarantee of completely steady economic growth; you have many other factors that affect the society. No human activity goes on in a perfectly steady way.

I have never argued that you will have perfect stability. What I have argued is that instead of offsetting other forces making for instability, as the monetary authorities always claim they do, deviations from the steady rate of monetary growth in fact operate to exacerbate other forces; they tend to make things worse. So stable monetary growth is not a prescription for Utopia. It is only a prescription for keeping the monetary authorities from introducing additional instability into a society.

The fundamental source of the prosperity of a country must rest in the initiative, the capacities for work and the capacities for thrift of the people. At most money is a lubricator that can make it easier for those fundamental forces to manifest themselves. At worst, money is a disturbance that can frustrate those fundamental forces.

Am I a Purist?

At a seminar for MBA students, Graduate School of Business, Cape Town, March 26, 1976.

My old teacher, Frank Knight, has a favourite story about a breed of ducks that flew in a V with the leader in front. Every now and then the ducks would veer off and go their own way. The leader would keep on flying until he looked behind him and saw they weren't there. Then he'd rush around and get in front of them again. Well, that's one way to have influence. It happens not to be my way, but I'm not a purist either. There's a great difference between simply accommodating existing circumstances and being willing to divide up reforms into pieces, one at a time. I don't regard that as being a purist.

How do people like myself have an influence? We don't have an influence by persuading people, because nobody changes unless he has to. When government has to change policy then the policy it adopts depends on what policies are lying around that have been worked out and are intellectually respectable. I believe that the role people like myself have is in contributing to the range of policies and options that are available, that have been thought through and kept alive until circumstances are right for their adoption.

Twenty years ago, you would have asked me why I was so utterly unrealistic as to talk about the possibility of floating exchange rates. "Don't you think you would have a little bit more influence if you weren't quite to pure," you might have said, "if you talked instead about a sliding peg or a managed float or something of that kind?" Well, nobody adopted a floating exchange rate because they were persuaded it was the right policy. The time simply came when you could no longer hold the pegged exchange rate. And if you ever want a marvelous example of my duck analogy it's the way the IMF has rushed to get in front of floating exchange rates because they don't want to lose their jobs.

Again, we have been preaching about quantity of money for a long time with little effect. In recent years there has been a widespread adoption of monetary aggregates as a guide to monetary policy – by the United States, by Germany, by Japan and by other countries. Why? Not because we persuaded people in the first place but because the earlier policy was an utter failure. Facts have made it impossible for the former orthodoxy to be continued. You've had a shift – but the shift depended on what alternatives were available. That's the way in which people like me can play a role.

11/1/12

"Pricing Health Care: The Folly of Buying Health Care at the Company Store"

by Milton Friedman

Wall Street Journal, 3 February 1993

Toward the end of World War II, I served as an instructor in a quality-control course for Navy procurement officers. It was held in Hershey, Pa. As I recall, we stayed at the Hershey Hotel, on the comer of Cocoa Avenue and Chocolate Boulevard, across the street from the Hershey Junior College, where the actual instruction took place, a block or so from the Hershey Department Store, and so on. You get the idea. The stench – or perfume – of paternalism was heavy in the air.

Early in the century such company towns, most far less benevolently paternalistic than Hershey, were common. Workers who were employed at mines or factories located far from large cities, in towns that typically had only a single major employer, were often required, or induced, to live in company housing and buy their food and other supplies at company stores. In effect, they were paid in kind rather than in cash – the so-called truck system. As Merle Travis put it in his song, made popular by Tennessee Ernie Ford: "You load 16 tons and what do you get?/ You get another day older and deeper in debt./Saint Peter, don't you call me, 'cause I can't go,/I owe my soul to the company store."

Reformers objected strongly to the practice, maintaining that workers should be paid in cash and be free to spend their incomes where they wanted. As the country grew and the isolated company town became far less common, reformers had their way and the payment of wages in cash became the norm. By the 1940s, Hershey was an isolated relic.

Not so today. The company town has been revived in one major area: medical care. It is taken for granted that workers should receive their pay partly in kind, in the form of medical care provided by the employer. How come? Why single out medical care? Surely food is no less essential to life than medical care. Why is it not at least as logical for workers to be required to buy their food at the company store as to be required to buy their medical care at the company store?

The revival of the company store has less to do with logic than with pure chance. It is a wonderful example of how one bad government policy leads to another.

During World War II, the government imposed wage and price controls, while at the same time financing wartime spending by printing money. The resulting inflationary pressure, along with price controls, produced shortages of all kinds, including labor. Firms competing to acquire labor at government-controlled wages started to offer medical care as a fringe benefit. That benefit proved particularly attractive to workers and spread rapidly.

Initially, employers did not report the value of the fringe benefit to the Internal Revenue Service as part of their workers' wages. It took some time before the IRS realized what was going on. When it did, it issued regulations requiring employers to include the value of medical care as part of reported employees' wages. By this time, workers had become accustomed to the tax exemption of that particular fringe benefit and made a big fuss. Congress responded by legislating that medical care provided by employers should be tax-exempt.

Wage and price controls ended but the tax-exemption of medical care provided by employers did not, which explains the survival of the company store in this area. That survival is unquestionably a major reason for the present crisis in medical care.

The obvious solution is to eliminate the tax exemption of medical care, in which case employers and employees would find it mutually advantageous to convert the fringe benefit to a cash wage supplement. However, this solution is widely regarded as not politically feasible.

An alternative often proposed is to continue the tax exemption but end the requirement that medical care be purchased through the company store. Let employers now providing medical care and their employees agree on a specified sum to be added to cash wages in lieu of employer-provided medical care. Let that sum be tax-exempt to the employee if deposited in a so-called medi-save account. Let employees have complete discretion over how they use that sum, provided they use it for medical care. If they do not use all of it, let it accumulate and under specified conditions be withdrawn by the employee for other purposes.

I have little doubt that the introduction of such medi-save accounts would significantly reduce the total cost of medical care. (A recent book by John Goodman and Gerald Musgrave, *Patient Power*, published by the Cato Institute, offers a thorough account of this proposal.) Employees who now have no incentive to economize on medical care, or to shop for the providers that best meet their needs economically, would be given an incentive to do so.

I hasten to add that this proposal is not a panacea for present difficulties. Medicare and Medicaid would still remain powerful impediments to the efficient and effective use of medical facilities and personnel.

10/10/12