Economic Freedom

This section will introduce students to concepts of Economic Freedom as articulated by Adam Smith, John Maynard Keynes, Friedrich von Hayek, Milton Friedman and other influential economist-philosophers. Students will learn how free markets raise living standards and will discuss the roles of economic growth, technology, public policy and foreign trade policy in a functioning market economy.

Additional Reading

Economic Freedom Web Site
Index of Economic Freedom

Online Videos
Commanding Heights (Chapters 2, 3, 11,12,18,19)

Milton Friedman Interview- Individual Liberty

Milton Friedman Interview – Greed

Milton Friedman – Self Interest 1

Milton Friedman – Self Interest 2

Economic freedom denotes the ability of members of a society to undertake economic direction and actions. This is a term used in economic and policy debates as well as a politico-economic philosophy. As with freedom generally, there are various definitions, but no universally accepted concept of economic freedom. One major approach to economic freedom comes from classical liberal and libertarian traditions emphasizing free markets, free trade and private property under free enterprise, while another extends the welfare economics study of individual choice, with greater economic freedom coming from a "larger" (in some technical sense) set of possible choices.[3] Other conceptions of economic freedom include freedom from want and the freedom to engage in collective bargaining.

The free market viewpoint defines economic liberty as the freedom to produce, trade and consume any goods and services acquired without the use of force, fraud or theft. This is embodied in the rule of law, property rights and freedom of contract, and characterized by external and internal openness of the markets, the protection of property rights and freedom of economic initiative. There are several indices of economic freedom that attempt to measure free market economic freedom. Empirical studies based on these rankings have found higher living standards, economic growth, income equality, less corruption and less political violence to be correlated with higher scores on the country rankings. It has been argued that the economic freedom indices generally lump together unrelated policies and policy outcomes to conceal negative correlations between economic growth and EF in some subcomponents.

Institutions of economic freedom

Rule of law

Free market advocates argue both that the rule of law requires economic freedom, and that economic freedom requires the rule of law. Friedrich Hayek argued that the certainty of law contributed to the prosperity of the West more than any other single factor. Other important principles of the rule of law are the generality and equality of the law, which require that all legal rules apply equally to everybody. These principles can be seen as safeguards against severe restrictions on liberty, because they require that all laws equally apply to those with political and coercive power as well as those who are governed. Principles of the generality and equality of the law exclude special privileges and arbitrary application of law, that is laws favoring one group at the expense of other citizens. According to Friedrich Hayek, equality before the law is incompatible with any activity of the government aiming to achieve the material equality of different people. He asserts that a state's attempt to place people in the same (or similar) material position leads to an unequal treatment of individuals and to a compulsory redistribution of income.

Private property rights

In the 1960s Alan Greenspan argued that economic freedom requires the gold standard for protection of savings from confiscation through inflation. According to the free market view, a secure system of private property rights is an essential part of economic freedom. Such systems include two main rights: the right to control and benefit from property and the right to transfer property by voluntary means. These rights offer people the possibility of autonomy and self-determination according to their personal values and goals. Economist Milton Friedman sees property rights as "the most basic of human rights and an essential foundation for other human rights."[18]With property rights protected, people are free to choose the use of their property, earn on it, and transfer it to anyone else, as long as they do it on a voluntary basis and do not resort to force, fraud or theft. In such conditions most people can achieve much greater personal freedom and development than under a regime of government coercion. A secure system of property rights also reduces uncertainty and encourages investments, creating favorable conditions for an economy to be successful. Empirical evidence suggests that countries with strong property rights systems have economic growth rates almost twice as high as those of countries with weak property rights systems, and that a market system with significant private property rights is an essential condition for democracy. According to Hernando de Soto, much of the poverty in the Third World countries is caused by the lack of Western systems of laws and well-defined and universally recognized property rights. De Soto argues that because of the legal barriers poor people in those countries cannot utilize their assets to produce more wealth. Pierre Proudhon, a socialist and anarchist thinker, argued that property is both theft and freedom. Many leftists dispute that private property means "economic freedom" and believe in a system where people can lay claim to things based on personal use.

Freedom of contract

Freedom of contract is the right to choose one's contracting parties and to trade with them on any terms and conditions one sees fit. Contracts permit individuals to create their own enforceable legal rules, adapted to their unique situations.[24] Parties decide whether contracts are profitable or fair, but once a contract is made they are obliged to fulfill its terms, even if they are going to sustain losses by doing so. Through making binding promises people are free to pursue their own interests. The main economic function of contracts is to provide transferability of property rights. Transferability largely depends on the enforceability of contracts, which is enabled by the judicial system. In Western societies the state does not enforce all types of contracts, and in some cases it intervenes by prohibiting certain arrangements, even if they are made between willing parties. However, not all contracts need to be enforced by the state. For example, in the United States there is a large number of third-party arbitration tribunals which resolve disputes under private commercial law.[25] Negatively understood, freedom of contract is freedom from government interference and from imposed value judgments of fairness. The notion of "freedom of contract" was given one of its most famous legal expressions in 1875 by Sir George Jessel.

“If there is one thing more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice. Therefore, you have this paramount public policy to consider – that you are not lightly to interfere with this freedom of contract.”

The doctrine of freedom of contract received one of its strongest expressions in the US Supreme Court case of Lochner v New York which struck down legal restrictions on the working hours of bakers.

Critics of the classical view of freedom of contract argue that this freedom is illusory when the bargaining power of the parties is highly unequal, most notably in the case of contracts between employers and workers. As in the case of restrictions on working hours, workers as a group may benefit from legal protections that prevent individuals agreeing to contracts that require long working hours. In its West Coast Hotel Co. v. Parrish decision in 1937, overturning Lochner, the Supreme Court cited an earlier decision.

"The legislature has also recognized the fact, which the experience of legislators in many States has corroborated, that the proprietors of these establishments and their operatives do not stand upon an equality, and that their interests are, to a certain extent, conflicting. The former naturally desire to obtain as much labor as possible from their employees, while the latter are often induced by the fear of discharge to conform to regulations which their judgment, fairly exercised, would pronounce to be detrimental to their health or strength. In other words, the proprietors lay down the rules and the laborers are practically constrained to obey them. In such cases, self-interest is often an unsafe guide, and the legislature may properly interpose its authority."

From this point on, the Lochner view of freedom of contract has been rejected by US courts.

Economic and political freedom

Some free market advocates argue that political and civil liberties have simultaneously expanded with market-based economies, and present empirical evidence to support the claim that economic and political freedoms are linked.

In *Capitalism and Freedom* (1962), Friedman further developed Friedrich Hayek's argument that economic freedom, while itself an extremely important component of total freedom, is also a necessary condition for political freedom. He commented that centralized control of economic activities was always accompanied with political repression. In his view, voluntary character of all transactions in a free market economy and wide diversity that it permits are fundamental threats to repressive political leaders and greatly diminish power to coerce. Through elimination of centralized control of economic activities, economic power is separated from political power, and the one can serve as counterbalance to the other. Friedman feels that competitive capitalism is especially important to minority groups, since impersonal market forces protect people from discrimination in their economic activities for reasons unrelated to their productivity.

Austrian School economist Ludwig von Mises argued that economic and political freedom were mutually dependent: "The idea that political freedom can be preserved in the absence of economic freedom, and vice versa, is an illusion. Political freedom is the corollary of economic freedom. It is no accident that the age of capitalism became also the age of government by the people."

In *The Road to Serfdom*, Hayek argued that "Economic control is not merely control of a sector of human life which can be separated from the rest; it is the control of the means for all our ends." Hayek criticized socialist policies as the slippery slope that can lead to totalitarianism.

Gordon Tullock has argued that "the Hayek-Friedman argument" predicted totalitarian governments in much of Western Europe in the late 20th century – which did not occur. He uses the example of Sweden, in which the government at that time controlled 63 percent of GNP, as an example to support his argument that the basic problem with *The Road to Serfdom* is "that it offered predictions which turned out to be false. The steady advance of government in places such as Sweden has not led to any loss of non-economic freedoms." While criticizing Hayek, Tullock still praises the classical liberal notion of economic freedom, saying, "Arguments for political freedom are strong, as are the arguments for economic freedom. We needn't make one set of arguments depend on the other."

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THE CONCISE ENCYCLOPEDIA OF ECONOMICS

Free Market

by Murray N. Rothbard

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Home | CEE | 2nd edition | Free Market

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Browse the CEE
by title
by author
by category
Biographies
Appendix
Index
1st Edition
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Frequently Asked Questions
FAQs about Searching CEE

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Quote of the Day
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"Free market" is a summary term for an array of exchanges that take place in society. Each exchange is undertaken as a voluntary agreement between two people or between groups of people represented by agents. These two individuals (or agents) exchange two economic goods, either tangible commodities or nontangible services. Thus, when I buy a newspaper from a newsdealer for fifty cents, the newsdealer and I exchange two commodities: I give up fifty cents, and the newsdealer gives up the newspaper. Or if I work for a corporation, I exchange my labor services, in a mutually agreed way, for a monetary salary; here the corporation is represented by a manager (an agent) with the authority to hire.

Both parties undertake the exchange because each expects to gain from it. Also, each will repeat the exchange next time (or refuse to) because his expectation has proved correct (or incorrect) in the recent past. Trade, or exchange, is engaged in precisely because both parties benefit; if they did not expect to gain, they would not agree to the exchange.

This simple reasoning refutes the argument against **FREE TRADE** typical of the "mercantilist" period of sixteenth- to eighteenth-century Europe and classically expounded by the famed sixteenth-century French essayist Montaigne. The mercantilists argued that in any trade, one party can benefit only at the expense of the other—that in every transaction there is a winner and a loser, an "exploiter" and an "exploited." We can immediately see the fallacy in this still-popular viewpoint: the willingness and even eagerness to trade means that both parties benefit. In modern game-theory jargon, trade is a win-win situation, a "positive-sum" rather than a "zero-sum" or "negative-sum" game.

How can both parties benefit from an exchange? Each one values the two goods or services differently, and these differences set the scene for an exchange. I, for example, am walking along with money in my pocket

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but no newspaper; the newsdealer, on the other hand, has plenty of newspapers but is anxious to acquire money. And so, finding each other, we strike a deal.

Two factors determine the terms of any agreement: how much each participant values each good in question, and each participant's bargaining skills. How many cents will exchange for one newspaper, or how many Mickey Mantle baseball cards will swap for a Babe Ruth, depends on all the participants in the newspaper market or the baseball card market—on how much each one values the cards as compared with the other goods he could buy. These terms of exchange, called "prices" (of newspapers in terms of money, or of Babe Ruth cards in terms of Mickey Mantles), are ultimately determined by how many newspapers, or baseball cards, are available on the market in relation to how favorably buyers evaluate these goods—in shorthand, by the interaction of their **SUPPLY** with the **DEMAND** for them.

Given the supply of a good, an increase in its value in the minds of the buyers will raise the demand for the good, more money will be bid for it, and its price will rise. The reverse occurs if the value, and therefore the demand, for the good falls. On the other hand, given the buyers' evaluation, or demand, for a good, if the supply increases, each unit of supply—each baseball card or loaf of bread—will fall in value, and therefore the price of the good will fall. The reverse occurs if the supply of the good decreases.

The market, then, is not simply an array; it is a highly complex, interacting latticework of exchanges. In primitive societies, exchanges are all barter or direct exchange. Two people trade two directly useful goods, such as horses for cows or Mickey Mantles for Babe Ruths. But as a society develops, a step-by-step process of mutual benefit creates a situation in which one or two broadly useful and valuable commodities are chosen on the market as a medium of indirect exchange. This money-commodity, generally but not always gold or silver, is then demanded not only for its own sake, but even more to facilitate a reexchange for another desired commodity. It is much easier to pay steelworkers not in steel bars but in money, with which the workers can then buy whatever they desire. They are willing to accept money because they know from experience and insight that everyone else in the society will also accept that money in payment.

The modern, almost infinite latticework of exchanges, the market, is made possible by the use of money. Each person engages in specialization, or a division of labor, producing what he or she is best at. Production begins with **NATURAL RESOURCES**, and then various forms of machines and capital goods, until finally, goods are sold to the consumer. At each stage of production from natural resource to consumer good, money is voluntarily exchanged for capital goods, labor services, and land resources. At each step of the way, terms of exchanges, or prices, are determined by the voluntary interactions of suppliers and demanders. This market is "free" because choices, at each step, are made freely and voluntarily.

The free market and the free price system make goods from around the world available to consumers. The free market also gives the largest possible scope to entrepreneurs, who risk capital to allocate resources so as to satisfy the future desires of the mass of consumers as efficiently as possible. **SAVING** and **INVESTMENT** can then develop capital goods and increase the **PRODUCTIVITY** and wages of workers, thereby increasing their standard of living. The free competitive market also rewards and stimulates technological **INNOVATION** that allows the innovator to get a head start in satisfying consumer wants in new and creative ways.

Not only is investment encouraged, but perhaps more important, the price system, and the profit-and-loss incentives of the market, guide capital investment and production into the proper paths. The intricate latticework can mesh and "clear" all markets so that there are no sudden, unforeseen, and inexplicable shortages and surpluses anywhere in the production system.

But exchanges are not necessarily free. Many are coerced. If a robber threatens you with, "Your money or your life," your payment to him is coerced and not voluntary, and he benefits at your expense. It is robbery, not free markets, that actually follows the mercantilist model: the robber benefits at the expense of the coerced. Exploitation occurs not in the free market, but where the coercer exploits his victim. In the long run, coercion is a negative-sum game that leads to reduced production, saving, and investment; a depleted stock of capital; and reduced productivity and living standards for all, perhaps even for the coercers themselves.

Government, in every society, is the only lawful system of coercion. **TAXATION** is a coerced exchange, and the heavier the burden of taxation on production, the more likely it is that **ECONOMIC GROWTH** will falter and decline. Other forms of government coercion (e.g.,

PRICE CONTROLS or restrictions that prevent new competitors from entering a market) hamper and cripple market exchanges, while others (prohibitions on deceptive practices, enforcement of contracts) can facilitate voluntary exchanges.

The ultimate in government coercion is **SOCIALISM**. Under socialist central planning the socialist planning board lacks a price system for land or capital goods. As even socialists like Robert Heilbroner now admit (see **SOCIALISM**), the socialist planning board therefore has no way to calculate prices or costs or to invest capital so that the latticework of production meshes and clears. The experience of the former Soviet Union, where a bumper wheat harvest somehow could not find its way to retail stores, is an instructive example of the impossibility of operating a complex, modern economy in the absence of a free market. There was neither incentive nor means of calculating prices and costs for hopper cars to get to the wheat, for the flour mills to receive and process it, and so on down through the large number of stages needed to reach the ultimate consumer in Moscow or Sverdlovsk. The investment in wheat was almost totally wasted.

Market socialism is, in fact, a contradiction in terms. The fashionable discussion of market socialism often overlooks one crucial aspect of the market: When two goods are exchanged, what is really exchanged is the property titles in those goods. When I buy a newspaper for fifty cents, the seller and I are exchanging property titles: I yield the ownership of the fifty cents and grant it to the newsdealer, and he yields the ownership of the newspaper to me. The exact same process occurs as in buying a house, except that in the case of the newspaper, matters are much more informal and we can avoid the intricate process of deeds, notarized contracts, agents, attorneys, mortgage brokers, and so on. But the economic nature of the two transactions remains the same.

This means that the key to the existence and flourishing of the free market is a society in which the rights and titles of private property are respected, defended, and kept secure. The key to socialism, on the other hand, is government ownership of the means of production, land, and capital goods. Under socialism, therefore, there can be no market in land or capital goods worthy of the name.

Some critics of the free market argue that **PROPERTY RIGHTS** are in conflict with “human” rights. But the critics fail to realize that in a free-market system, every person has a property right over his own person and his own labor and can make free contracts for those services. Slavery violates the basic property right of the slave over his own body and person, a right that is the groundwork for any person's property rights over nonhuman material objects. What is more, all rights are human rights, whether it is everyone's right to free speech or one individual's property rights in his own home.

A common charge against the free-market society is that it institutes "the law of the jungle," of "dog eat dog," that it spurns human cooperation for **COMPETITION** and exalts material success as opposed to spiritual values, philosophy, or leisure activities. On the contrary, the jungle is precisely a society of coercion, theft, and parasitism, a society that demolishes lives and living standards. The peaceful market competition of producers and suppliers is a profoundly cooperative process in which everyone benefits and where everyone's living standard flourishes (compared with what it would be in an unfree society). And the undoubted material success of free societies provides the general affluence that permits us to enjoy an enormous amount of leisure as compared with other societies, and to pursue matters of the spirit. It is the coercive countries with little or no market activity—the notable examples in the last half of the twentieth century were the communist countries—where the grind of daily existence not only impoverishes people materially but also deadens their spirit.

About the Author

Murray N. Rothbard, who died in 1995, was the S. J. Hall Distinguished Professor of Economics at the University of Nevada in Las Vegas. He was also the leading Austrian economist of the last half of the twentieth century. This article was edited slightly to reflect the demise of various communist countries.

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Free-market system improves standards of living

05/06/07

By Hal Heaton

PRINTED IN THE DESERET NEWS

I recently read an article in which the author was complaining about income inequality. He drew what he referred to as an "inescapable conclusion" that when one person lives a life of luxury in a nation or a world of finite resources, others are forced to have less. He implied that we need to have more central government planning and control to more equitably distribute resources.

I disagree. To me, that's the same perspective that would have been shared by the hunter/gatherers of 10,000 years ago, who were always on the verge of starvation. They would have been terrified at the prospect of a world populated by 6 billion people, and probably would have had the same zero-sum mentality the author exhibits.

Of course, what we really have today with 6 billion people are standards of living, life expectancies, varieties of foods, products and services that the hunter/gatherers could only dream of - all courtesy of the free market system.

The fact is, life is not a zero sum game. Free markets (capitalism) by their very nature create new and better ways of doing things. People were terrified about how they were going to light lamps when the world was growing short of whales. We now have a better way. Capitalism provides incentives to deal with the finite nature of the planet. Constraints - natural or man-made - cause prices to move and create incentives to find alternatives.

ago they were in essentially the same economic circumstances following the Korean War. Today, people in North Korea are dying of starvation - an estimated 2 million just since the turn of the century. Under the capitalistic society of South Korea, people have a standard of living well beyond that of North Korea.

Similarly, you can compare Taiwan and mainland China before China opened up to capitalism and see the same thing. The higher standard of living is associated with political and economic freedom. In fact, I would suggest that the higher standard of living is the direct result of that freedom. I also assert that China's opening up to capitalism has released hundreds of millions of people from poverty.

If the author's hypothesis were correct, poor people everywhere would be flocking to get into the paradise of totalitarian systems. I think it's pretty clear that people risk their lives to flee the systems the author is advocating. Even the soft socialism of Mexico causes people to flee to the American system.

Of course, the author is probably advocating a more progressive tax system. In that case I would point out that in the United States, the bottom 40 percent of taxpayers pay a net zero percent of income taxes due to the earned income tax credit. The top 20 percent of taxpayers earn 50 percent of income and pay more than 80 percent of income taxes. Even the Social Security system is set up so that the lower-income people get substantially more for

Compare the development of new surgical/pharmaceutical/health-care treatments under capitalism versus centrally planned economies like communism or socialism. Virtually all progress has come from free-market economies. Planned economies have directly benefited from the technological improvements coming out of capitalism - it is rarely the other way around.

As I continued to read the article mentioned above it became clear that the author was suggesting that if people don't give enough money to the poor to provide more economic balance in society, government should essentially play Robin Hood and take from the rich to give to the poor. Based on the historical record of centralized government power, I am terrified by the author's suggestion.

Take, for example, the comparative experience of North and South Korea. Fifty years every dollar contributed to the system than upper-income contributors.

Historical statistics indicate that income inequality increases and the percentage of taxes paid by the highest 20 percent of income earners decreases when tax rates are increased. But when tax rates are decreased, income inequality decreases and the percentage of income taxes paid by the highest income earners increases. Interestingly, a recent study suggests that people who advocate lower tax rates overwhelmingly donate more of their income to charity than those who advocate higher tax rates.

For me the bottom line is this: If the author of that article is saying that people should give more of what they have to the poor of their own free will, I agree. But if he is trying to suggest that the government should start imposing his value system on our economy, then I most strongly disagree.

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(1723-1790)

The 18th-century Scottish philosopher Adam Smith is credited with writing the first great work on political economy. His treatise The Wealth of Nations *describes the evolution and political organization of civilizations, from hunter-gatherer societies to commercially interdependent ones.*

From "Smith Adam." Microsoft Encarta Encyclopedia 2001.

Adam Smith was a British philosopher and economist. His celebrated treatise "An Inquiry into the Nature and Causes of the Wealth of Nations" was the first serious attempt to study the nature of capital and the historical development of industry and commerce among European nations.

Smith was born in Kirkcaldy, Scotland, and educated at the universities of Glasgow and Oxford. From 1748 to 1751, he gave lectures on rhetoric and belles-lettres in Edinburgh. During this period, a close association developed between Smith and the Scottish philosopher David Hume that lasted until the latter's death in 1776 and contributed much to the development of Smith's ethical and economic theories.

Smith was appointed professor of logic in 1751 and then professor of moral philosophy in 1752 at the University of Glasgow. He later systematized the ethical teachings he had propounded in his lectures and published them in his first major work, *Theory of Moral Sentiments* (1759). In 1763 he resigned from the university to accept the position of tutor to Henry Scott, 3rd duke of Buccleuch, whom he accompanied on an 18-month tour of France and Switzerland. Smith met and associated with many of the leading continental philosophers of the physiocratic school, which based its political and economic doctrines on the supremacy of natural law, wealth, and order. He was particularly influenced by the French philosophers Francois Quesnay and Anne Robert Jacques Turgot, whose theories Smith later adapted in part to form a basis for his own. From 1766 to 1776, he lived in Kirkcaldy, preparing *The Wealth of Nations* (1776). Smith was appointed commissioner of customs in Edinburgh in 1778, serving in this capacity until his death. In 1787 he was also named lord rector of the University of Glasgow.

Smith's *Wealth of Nations* represents the first serious attempt in the history of economic thought to divorce the study of political economy from the related fields of political science, ethics, and jurisprudence. It embodies a penetrating analysis of the processes whereby economic wealth is produced and distributed and demonstrates that the fundamental sources of all income, that is, the basic forms in which wealth is distributed, are rent, wages, and profits.

The central thesis of *The Wealth of Nations* is that capital is best employed for the production and distribution of wealth under conditions of governmental noninterference, or laissez-faire, and free trade. In Smith's view, the production and exchange of goods can be stimulated, and a consequent rise in the general standard of living attained, only through the efficient operations of private industrial and commercial entrepreneurs acting with a minimum of regulation and control by governments. To explain this concept of government maintaining a laissez-faire attitude toward commercial endeavors, Smith proclaimed the principle of the "invisible hand": Every individual in pursuing his or her own good is led, as if by an invisible hand, to achieve the best good for all. Therefore any interference with free competition by government is almost certain to be injurious.

Although this view has undergone considerable modification by economists in the light of historical developments since Smith's time, many sections of *The Wealth of Nations,* notably those relating to the sources of income and the nature of capital, have continued to form the basis for theoretical study in the field of political economy. *The Wealth of Nations* has also served, perhaps more than any other single work in its field, as a guide to the formulation of governmental economic policies.

TITLE:: Adam Smith and the Origin of Capitalism

SUBTITLE::

SOURCE:: Excerpt and condensation of Chapter 4 from <i>The Worldly Philosophers: The Lives, Times, and Ideas of the Great Economic Thinkers</i> by Robert L. Heilbroner, 7th ed., 1999.

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TAGS:: Adam Smith, Smith, The Wealth of Nations, capitalism, market, markets, free market, system of perfect liberty, liberty and profit, self interest, competition

COUNTRIES:: Europe

YEARS:: 1776-1800

INTRO:: Robert Heilbroner's <i>The Worldly Philosophers</i> is a uniquely readable introduction to the lives and ideas of the great economic theorists of the last three centuries. The book has enlivened the study of economics for beginning students for more than 40 years.

Adam Smith published his <i>Inquiry into the Nature and Causes of the Wealth of Nations</i> in 1776, adding a second revolutionary event to that fateful year. A political democracy was born on one side of the ocean; an economic blueprint was unfolded on the other. But while not all Europe followed America's political lead, after Smith had displayed the first true tableau of modern society, all the Western world became the world of Adam Smith: his vision became the prescription for the spectacles of generations. Adam Smith would never have thought of himself as a revolutionist; he was only explaining what to him was very clear sensible, and conservative. But he gave the world the image of itself for which it had been searching. After <i>The Wealth of Nations,</i> men began to see the world about themselves with new eyes; they saw how the tasks they did fitted into the whole of society, and they saw that society as a whole was proceeding at a majestic pace toward a distant but clearly visible goal. In a word, a new vision had come into being.

What was that new vision? As we might expect, it was not a State but a System -- more precisely, a System of Perfect Liberty. Smith's vision is like a blueprint for a whole new mode of social organization, a mode called Political Economy, or, in today's terminology, economics.

The Laws of the Market

At the center of this blueprint are the solutions to two problems that absorb Smith's attention. First, he is interested in laying bare the mechanism by which society hangs together. How is it possible for a community in which everyone is busily following his self-interest not to fly apart from sheer centrifugal force? What is it that guides each individual's private business so that it conforms to the needs of the group? With no central planning authority and no steadying influence of age-old tradition, how does society manage to get those tasks done which are necessary for survival?

These questions lead Smith to a formulation of the laws of the market. What he sought was "the invisible hand," as he called it, whereby "the private interests and passions of men" are led in the direction "which is most agreeable to the interest of the whole society."

But the laws of the market will be only a part of Smith's inquiry. There is another question that interests him: whither society? The laws of the market are like the laws that explain how a spinning top stays upright; but there is also the question of whether the top, by virtue of its spinning, will be moved along the table.

To Smith and the great economists who followed him, society is not conceived as a static achievement of mankind which will go on reproducing itself, unchanged and unchanging, from one generation to the next. On the contrary, society is seen as an organism that has its own life history. Indeed, in its entirety <i>The Wealth of Nations</i> is a great treatise on history, explaining how "the system of perfect liberty" (also called "the system of natural liberty") -- the way Smith referred to commercial capitalism -- came into being, as well as how it worked.

Adam Smith's laws of the market are basically simple. They tell us that the outcome of a certain kind of behavior in a certain social framework will bring about perfectly definite and foreseeable results. Specifically they show us how the drive of individual self-interest in an environment of similarly motivated individuals will result in competition; and they further demonstrate how competition will result in the provision of those goods that society wants, in the quantities that society desires, and at the prices society is prepared to pay.

But self-interest is only half the picture. It drives men to action. Something else must prevent the pushing of profit hungry individuals from holding society up to exorbitant ransom. This regulator is competition, the conflict of the self-interested actors on the marketplace. A man who permits his self-interest to run away with him will find that competitors have slipped in to take his trade away. Thus the selfish motives of men are transmuted by interaction to yield the most unexpected of results: social harmony.

But the laws of the market do more than impose a competitive price on products. They also see to it that the producers of society heed society's demands for the quantities of goods it wants. Let us suppose that consumers decide they want more gloves than are being turned out, and fewer shoes. Accordingly the public will scramble for the stock of gloves on the market, while the shoe business will be dull. As a result glove prices will tend to rise, and shoe prices will tend to fall. But as glove prices rise, profits in the glove industry will rise, too; and as shoe prices fall, profits in shoe manufacture will slump. Again self-interest will step in to right the balance. Workers will be released from the shoe business as shoe factories contract their output; they will move to the glove business, where business is booming. The result is quite obvious: glove production will rise and shoe production fall.

Through the mechanism of the market, society will have changed the allocation of its elements of production to fit its new desires. Yet no one has issued a dictum, and no planning authority has established schedules of output. Self-interest and competition, acting one against the other, have accomplished the transition.

And one final accomplishment. Just as the market regulates both prices and quantities of goods according to the final arbiter of public demand, so it also regulates the incomes of those who cooperate to produce those goods. If profits in one line of business are unduly large, there will be a rush of other businessmen into that field until competition has lowered surpluses. If wages are out of line in one kind of work, there will be a rush of men into the favored occupation until it pays no more than comparable jobs of that degree of skill and training. Conversely, if profits or wages are too low in one trade area, there will be an exodus of capital and labor until the supply is better adjusted to the demand.

All this may seem somewhat elementary. But consider what Adam Smith has done, he has found in the mechanism of the market a self-regulating system for society's orderly provisioning.

Does the world really work this way? To a very real degree it did in the days of Adam Smith. Business was competitive, the average factory was small, prices did rise and fall as demand ebbed and rose, and changes in prices did invoke changes in output and occupation.

And today? Does the competitive market mechanism still operate?

This is not a question to which it is possible to give a simple answer. The nature of the market has changed vastly since the 18th century. We no longer live in a world of atomistic competition in which no man can afford to swim against the current. Today's market mechanism is characterized by the huge size of its participants: giant corporations and strong labor unions obviously do not behave as if they were individual proprietors and workers. Their very bulk enables them to stand out against the pressures of competition, to disregard price signals, and to consider what their self-interest shall be in the long run rather than in the immediate press of each day's buying and selling.

That these factors have weakened the guiding function of the market mechanism is apparent. But for all the attributes of modern-day economic society, the great forces of self-interest and competition, however watered down or hedged about, still provide basic rules of behavior that no participant in a market system can afford to disregard entirely. Although the world in which we live is not that of Adam Smith, the laws of the market can still be discerned if we study its operations....

Smith's View of Economic Growth

"No society can surely be flourishing and happy, of which by far the greater part of the numbers are poor and miserable," he wrote. And not only did he have the temerity to make so radical a statement, but he proceeded to demonstrate that society was in fact constantly improving; that it was being propelled, willy-nilly, toward a positive goal. It was not moving because anyone willed it to, or because Parliament might pass laws, or England win a battle. It moved because there was a concealed dynamic beneath the surface of things which powered the social whole like an enormous engine.

For one salient fact struck Adam Smith as he looked at the English scene. This was the tremendous gain in productivity which sprang from the minute division and specialization of labor.

There is hardly any need to point out how infinitely more complex present-day production methods are than those of the 18th century. Smith was sufficiently impressed with a small factory of ten people to write about it; what would he have thought of one employing ten thousand! But the great gift of the division of labor lies in its capacity to increase what Smith calls "that universal opulence which extends itself to the lowest ranks of the people." That universal opulence of the 18th century looks like a grim existence from our modern vantage point. But if we view the matter in its historical perspective , it is clear that, mean as his existence was, it constituted a considerable advance.

What is it that drives society to this wonderful multiplication of wealth and riches? Partly it is the market mechanism itself, for the market harnesses man's creative powers in a milieu that encourages him, even forces him, to invent, innovate, expand, take risks. But there are more fundamental pressures behind the restless activity of the market. In fact, Smith sees two deep-seated laws of behavior which propel the market system in an ascending spiral of productivity.

The first of these is the Law of Accumulation. The object of the great majority of the rising capitalists was first, last, and always, to accumulate their savings.

But Adam Smith did not approve of accumulation for accumulation's sake. He was, after all, a philosopher, with a philosopher's disdain for the vanity of riches. Rather, in the accumulation of capital Smith saw a vast benefit to society. For capital -- if put to use in machinery -- provided just that wonderful division of labor which multiplies man's productive energy. Accumulate and the world will benefit, says Smith.

But here is a difficulty: accumulation would soon lead to a situation where further accumulation would be impossible. For accumulation meant more machinery, and more machinery meant more demand for workmen. And this in turn would sooner or later lead to higher and higher wages, until profits -- the source of accumulation -- were eaten away. How is this hurdle surmounted?

It is surmounted by the second great law of the system: the Law of Population.

To Adam Smith, laborers, like any other commodity, could be produced according to the demand. If wages were high, the number of workpeople would multiply; if wages fell, the numbers of the working class would decrease. Smith put it bluntly: "... the demand for men, like that for any other commodity, necessarily regulates the production of men."

If the first effect of accumulation would be to raise the wages of the working class, this in turn would bring about an increase in the number of workers. And now the market mechanism takes over. Just as higher prices on the market will bring about a larger production of gloves and the larger number of gloves in turn press down the higher prices of gloves, so higher wages will bring about a larger number of workers, and the increase in their numbers will set up a reverse pressure on the level of their wages.

And this meant that accumulation might go safely on. The rise in wages which it caused and which threatened to make further accumulation unprofitable is tempered by the rise in population. Smith has constructed for society a giant endless chain. As regularly and as inevitably as a series of interlocked mathematical propositions, society is started on an upward march. From any starting point the probing mechanism of the market first equalizes the returns to labor and capital in all their different uses, sees to it that those commodities demanded are produced in the right quantities, and further ensures that prices for commodities are constantly competed down to their costs of production. But further than this, society is dynamic. From its starting point accumulation of wealth will take place, and this accumulation will result in increased facilities for production and in a greater division of labor.

This is no business cycle that Smith describes. It is a long-term process, a secular evolution. And it is wonderfully certain. Provided only that the market mechanism is not tampered with, everything is inexorably determined by the preceding link. A vast reciprocating machinery is set up with all of society inside it: only the tastes of the public -- to guide producers -- and the actual physical resources of the nation are outside the chain of cause and effect.

But observe that what is foreseen is not an unbounded improvement of affairs. There will assuredly be a long period of what we call economic growth but the improvement has its limits. In the very long run, well beyond the horizon, he saw that a growing population would push wages back to their "natural" level. Growth would come to an end when the economy had extended its boundaries to their limits, and then fully utilized its increased economic "space."

Smith did not see the organizational and technological core of the division of labor as a self-generating process of change, but as a discrete advance that would impart its stimulus and then disappear. For all its optimistic boldness, Smith's vision is bounded, careful, sober -- for the long run, even sobering.

No wonder, then, that the book took hold slowly. It was not until 1800 that the book achieved full recognition. By that time it had gone through nine English editions and had found its way to Europe and America. Its protagonists came from an unexpected quarter. They were the rising capitalist class excoriated for its "mean rapacity." All this was ignored in favor of the great point that Smith made in his inquiry: let the market alone.

In Smith's panegyric of a free and unfettered market the rising industrialists found the theoretical justification they needed to block the first government attempts to remedy the scandalous conditions of the times. For Smith's theory does unquestionably lead to a doctrine of laissez-faire. To Adam Smith the least government is certainly the best: governments are spendthrift, irresponsible, and unproductive. And yet Adam Smith is not necessarily opposed to government action that has as its end the promotion of the general welfare.

Government's Economic Role

Smith specifically stresses three things that government should do in a society of natural liberty. First, it should protect that society against "the violence and invasion of other societies. Second, it should provide an "exact administration of justice" for all citizens. And third, government has the duty of "erecting and maintaining those public institutions and those public works which may be in the highest degree advantageous to a great society," but which "are of such a nature that the profit could never repay the expense to any individual or small number of individuals."

Put into today's language, Smith explicitly recognizes the usefulness of public investment for projects that cannot be undertaken by the private sector -- he mentions roads and education as two examples.

What Smith is against is the meddling of the government with the market mechanism. He is against restraints on imports and bounties on exports, against government laws that shelter industry from competition, and against government spending for unproductive ends. These activities of the government all bear against the proper working of the market system. Smith never faced the problem that was to cause such intellectual agony for later generations of whether the government is weakening or strengthening that system when it steps in with welfare legislation.

The Danger of Monopoly

The great enemy to Adam Smith's system is not so much government per se as monopoly in any form. The trouble with such goings-on is not so much that they are morally reprehensible in themselves -- they are, after all, only the inevitable consequence of man's self-interest -- as that they impede the fluid working of the market. Whatever interferes with the market does so only at the expense of the true wealth of the nation.

In a sense the vision of Adam Smith is a testimony to the 18th-century belief in the inevitable triumph of rationality and order over arbitrariness and chaos. Don't try to do good, says Smith. Let good emerge as the by-product of selfishness.

Smith was the economist of pre-industrial capitalism; he did not live to see the market system threatened by enormous enterprises; or his laws of accumulation and population upset by sociological developments fifty years off. When Smith lived and wrote, there had not yet been a recognizable phenomenon that might be called a "business cycle." The world he wrote about actually existed, and his systematization of it provides a brilliant analysis of its expansive propensities.

Yet something must have been missing from Smith's conception. For although he saw an evolution for society, he did not see a revolution -- the Industrial Revolution. Smith did not see in the ugly factory system, in the newly tried corporate form of business organization, or in the weak attempts of journeymen to form protective organizations, the first appearance of new and disruptively powerful social forces. In a sense his system presupposes that 18th-century England will remain unchanged forever. Only in quantity will it grow: more people, more goods, more wealth; its quality will remain unchanged. His are the dynamics of a static community; it grows but it never matures.

But, although the system of evolution has been vastly amended, the great panorama of the market remains as a major achievement.

For Smith's encyclopedic scope and knowledge there can be only admiration. <i>The Wealth of Nations</i> and <i>The Theory of Moral Sentiments,</i> together with his few other essays, reveal that Smith was much more than just an economist. He was a philosopher-psychologist-historian-sociologist who conceived a vision that included human motives and historic "stages" and economic mechanisms, all of which expressed the plan of the Great Architect of Nature (as Smith called him). From this viewpoint, <i>The Wealth of Nations</i> is more than a masterwork of political economy. It is part of a huge conception of the human adventure itself.

(1883-1946)

John Maynard Keynes was a British economist during the first half of the 20th century best known for his revolutionary theories on the causes of unemployment and recession, which came to be known as Keynesian economics.

Excerpted from *The Commanding Heights* by Daniel Yergin and Joseph Stanislaw, 1998 ed., pp. 39-42.

The most influential economist of the 20th century, John Maynard Keynes was a product of the late Victorian and Edwardian eras, a period when stability, prosperity, and peace were assumed and when Britain ruled the world economy. Keynes never lost the self-confidence, self-assurance, and indeed the optimism of that time. But his intellectual career, and his profound impact, arose from his efforts to make sense of the disruptions and crises that began with the first world war and continued through the Great Depression.

Descended from a knight who had crossed the English Channel with William the Conqueror, Keynes was the son of a Cambridge University economist. Educated at Eton and Cambridge, he demonstrated from his early years a dazzling, wide-ranging intellect, along with an arrogance and what seemed to some a dismissive elitism. His establishment habits (including the signature homburg normally associated with a City of London stockbroker) and his pride in being a member of what he called the "educated bourgeoisie" were combined with chronic social and intellectual rebellion, orneriness, and the lifestyle of a Bloomsbury bohemian and aesthete. His daunting mathematical dexterity was complemented by a considerable literary grace, whether the subject was the subtleties of economic thought or his obsession with the hands of statesmen. He celebrated "vigilant observation" of the real world as one of the requirements of a good economist, and he loved to pore through statistics. His best ideas, he liked to say, came "from messing about with figures and seeing what they must mean." Nevertheless, he could not resist endlessly toying with ideas, and he compulsively sought to spin out all-encompassing theories and generalizations from particulars.

As an economic advisor to the British delegation at the Versailles conference in 1919, he became convinced that the Carthaginian peace that the Allies were imposing on Germany would undermine European economic recovery and guarantee new crises. Disgusted, he resigned and retired to the English countryside, where, in a matter of weeks, he brought together his searing criticisms in *The Economic Consequences of the Peace.* That book made him famous. In the 1920s, he focused mostly on monetary issues. He lambasted the decision by Winston Churchill, at the time chancellor of the exchequer, to return Britain to the gold standard with an overvalued pound in a work entitled "The Economic Consequences of Mr. Churchill."

During those years and into the 1930s, he split his week between King's College in Cambridge, where he did his teaching, and London, where he busied himself speculating in currencies, commodities, and stocks. He was also on the board of a number of investment and insurance companies, and in fact served as the chairman of one. He was a master of markets and their psychology. As bursar of King's College—during the Great Depression—he increased the college's endowment tenfold. He also made himself very wealthy managing his own portfolio, despite periodic reverses. He did not hesitate to take risks. "The academic economist," said a close friend of Keynes, "never really knows what makes a businessman tick, why he wants sometimes to gamble on an investment project and why he sometimes prefers liquidity and cash. Maynard understood because he was a gambler himself and felt the gambling or liquidity instincts of the businessman." As Keynes himself once explained, "Business life is always a bet."

Persistent unemployment in Britain, and then the mass unemployment of the Great Depression, redirected Keynes's intellectual agenda from monetary affairs to unemployment and led to his most influential work, *The General Theory of Employment, Interest, and Money,* published in 1936. Here was Keynes as vigilant observer, keen mathematician, self-confident rebel, and grand generalizer. The book constituted a vast assault on the classical economics tradition in which he had been raised. The era that had nurtured classical economics had been destroyed by the first world war, and for Keynes the cataclysms since had demonstrated the tradition's inadequacies. A new synthesis was necessary, and that is what Keynes, working with his "kindergarten" of disciples in Cambridge, sought to create.

In particular, he concluded that classical economics rested on a fundamental error. It assumed, mistakenly, that the balance between supply and demand would ensure full employment. On the contrary, in Keynes's view, the economy was chronically unstable and subject to fluctuations, and supply and demand could well balance out at an equilibrium that did not deliver full employment. The reasons were inadequate investment and over-saving, both rooted in the psychology of uncertainty.

The solution to this conundrum was seemingly simple: Replace the missing private investment with public investment, financed by deliberate deficits. The government would borrow money to spend on such things as public works; and that deficit spending, in turn, would create jobs and increase purchasing power. Striving to balance the government's budget during a slump would make things worse, not better. In order to make his argument, Keynes deployed a range of new tools—standardized national income accounting (which led to the basic concept of gross national product), the concept of aggregate demand, and the multiplier (people receiving government money for public-works jobs will spend money, which will create new jobs). Keynes's analysis laid the basis for the field of macroeconomics, which treats the economy as a whole and focuses on government's use of fiscal policy—spending, deficits, and tax. These tools could be used to manage aggregate demand and thus ensure full employment. As a corollary, the government would cut back its spending during times of recovery and expansion. This last precept, however, was all too often forgotten or overlooked.

Keynes intended government to play a much larger role in the economy. His vision was one of reformed capitalism, managed capitalism—capitalism saved both from socialism and from itself. He talked about a "somewhat comprehensive socialization of investment" and the state's taking "an ever greater responsibility for directly organizing investment." Fiscal policy would enable wise managers to stabilize the economy without resorting to actual controls. The bulk of decision making would remain with the decentralized market rather than with the central planner.

Keynes had worked on *The General Theory* with feverish intensity, convinced that new apocalypses were waiting close in the wings even as the world struggled with the Depression. The alternative to reform was totalitarianism. And it was not only the new vistas of macroeconomics but also the dangers of the time that helped explain the fervor with which others embraced the argument. As one of his students explained, "Finally what Keynes supplied was hope: hope that prosperity could be restored and maintained without the support of prison camps, executions, and bestial interrogations."

A new apocalypse came soon enough. With the outbreak of World War II, Keynes moved on to the questions of how to finance the war and then how to develop a postwar currency system. He was one of the fathers of the Bretton Woods accord, which established the World Bank and the International Monetary Fund, and which put in place a system of fixed exchange rates. He also returned to a subject that had obsessed him since the first world war—how to cope with, and limit, Britain's submission to America's financial might. After all, he had come to maturity in an age when Britain ruled the international economy. Now, however distastefully, he struggled to adjust Britain to the new reality of American ascendancy. His last major enterprise was to negotiate a multibillion-dollar U.S. loan for Britain in 1946. It was a very nasty business. The stress literally killed him.

Keynes provided both a specific rationale for government's taking a bigger role in the economy and a more general confidence in the ability of government to intervene and manage effectively. As Keynes's work turned into "Keynesianism" in the post-World War II years, the self-confidence that had animated its author continued to be at its root. Despite Keynes's fascination with uncertainty and his speculative talents in the marketplace, Keynesians deemed "government knowledge" to be superior to that of the marketplace. In the words of Keynes's biographer Robert Skidelsky, the unstated message in its most extreme form was this: "The state is wise and the market is stupid."

In one of the most famous passages of *The General Theory,* Keynes had written, "The power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." There was nothing gradual, however, in the encroachment of Keynesianism or in its conquest of the commanding heights of economic thinking. Within a few years of his death, it was already taking a dominant place in economic policy making both in Britain and in the United States. How far-reaching its impact, or at least the perception of its impact, was demonstrated by a history of economic thought published in the mid-1960s: "In most Western economies Keynesian theory has laid the intellectual foundations for a managed and welfare-oriented form of capitalism. Indeed, the widespread absorption of the Keynesian message has in large measure been responsible for the generally high levels of employment achieved by most Western industrial countries since the second world war and for a significant reorientation in attitudes toward the role of the state in economic life." Keynes's self-confidence lived on in his thought.

John Maynard Keynes's most influential work, *The General Theory of Employment, Interest, and Money,* was published in 1936. The book constituted a vast assault on the classical economics tradition in which he had been raised. The era that had nurtured classical economics had been destroyed by the first world war, and for Keynes the cataclysms since had demonstrated the tradition's inadequacies. A new synthesis was necessary, and that is what Keynes sought to create.

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It was not until the 1970s that evidence began to accumulate in many countries that Keynes's theories, at least as implemented by Keynes's advocates after his death, might not perpetually yield the favorable outcomes Keynes himself had predicted.

(1899-1992)

Born in Austria in 1899, Nobel Prize-winning economist Friedrich von Hayek was an advocate of free-market capitalism. He is known for his criticism of the prevailing economic theories of the 20th century, Keynesian economic models and socialism.

Excerpt from *The Commanding Heights* by Daniel Yergin and Joseph Stanislaw, 1998 ed., pp. 141-144.

In retrospect, it was the awarding of the 1974 Nobel Prize in economics that first captured, almost by chance, the great intellectual change. The Swedish academy wanted to honor Gunnar Myrdal, distinguished Keynesian, a father of development economics, and a great figure of Swedish socialism. But the grantors, worried about the appearance of choosing so local a favorite, decided that they ought to balance the ticket with a more conservative figure, and they awarded the prize to Myrdal jointly with Friedrich von Hayek. A good part of the economics profession was scandalized by the choice of Hayek; many economists in the United States, if polled, would have hardly even considered him an economist. He was regarded as right-wing, certainly not mainstream, even something of a crank as well as a fossil from an archaic era....

Yet the award documented the beginning of a great shift in the intellectual center of gravity of the economies profession toward a restoration of confidence in markets, indeed a renewed belief in the superiority of markets over other ways of organizing economic activity. Within a decade and a half, the shift would be largely complete. And the eventual victory of this viewpoint was really a tale of two cities—Vienna and Chicago.

Friedrich von Hayek was the figure who tied the two together; he also connected the post-World War I Austrian School of economics to the renewed embrace of markets in the 1980s. A product of the Austro-Hungarian Empire and its collapse, Hayek was shaped by the vibrant, vital culture of Vienna both before World War I and, in its more tortured form, after the war. A second cousin to the philosopher Ludwig Wittgenstein, he came from a family of biologists and government officials, and he was headed toward his father's career, botany. But then World War I fundamentally changed his outlook. As a junior officer in the war, he came face to face with the complexities and dangers of nationalistic fervor. "I saw, more or less, the great empire collapse over the nationalist problem," he later said. "I served in a battle in which eleven different languages were spoken. It's bound to draw your attention to the problems of political organization." The war also left him with a compulsion to find an answer to "the burning question" of how to build a "juster society."

To that end, returning to Vienna after the war, Hayek earned doctorates in both economics and law. He went to New York City in 1923 and enrolled in the Ph.D. program at New York University. But he ran out of money and returned to Vienna to continue his work in economics. The war drove him, like many of his young contemporaries, toward an idealistic search for renewal, a quest for a better world—which meant socialism. "We felt that the civilization in which we had grown up had collapsed," he later said. "This desire to reconstruct society led many of us to the study of economics. Socialism promised to fulfill our hopes for a more rational, more just world." But then, as he began to study economics, he went through a painful and reluctant reassessment, in which he concluded that his idealistic objectives could be better served through a market economy.

His transformation occurred under the influence of Ludwig von Mises, the most prominent member of the Austrian School of economics. In his book *Socialism*, published in 1922, Mises presented a devastating analysis of the central economic failing of socialism. He called it the economic calculation. The problem was that under central planning, there was no economic calculation—no way to make a rational decision to put this resource here or buy that good there, because there was no price system to weigh the alternatives. Central planners could make technical decisions but not economic ones. Over the rest of the century, that criticism would prove to be extraordinarily prescient. "Socialism shocked our generation," Hayek later said. Yet, he added, it profoundly altered the outlook of idealists returning from the war. "I know, for I was one of them.... Socialism told us that we had been looking for improvement in the wrong direction."

Hayek became Mises's student and then, for several years, his research assistant. Owing to the postwar Austrian inflation, he learned firsthand, in his very first job, what inflation could mean. He began at 500 kronen a month. Nine months later, his salary had swollen to one million kronen a month. In 1931 Hayek was invited to become a professor at the London School of Economics (LSE). The invitation was proffered by William Beveridge (who would author the Beveridge Report a decade later) but was at the specific instance of Lionel Robbins, the outstanding British liberal economist. In his inaugural address at LSE, Hayek declared that it was "almost inevitable" that any "warm-hearted person, as soon as he becomes conscious of the existing misery, should become a socialist." But economic study would bring that person to a more conservative point of view. This would happen to people who "have all possible sympathy with the ethical motives" from which radicalism springs and who "would be only too glad if they could believe that socialism or planning can do what they promise to do."

The London School of Economics had been founded by the Fabian socialists in 1895, and since the 1930s it had had a reputation as a leftist institution, dominated by socialists and devoted to propagating leftwing doctrines both in Britain and to the young people who went to study there from around the world. Yet by the 1930s, LSE's economics department, with Robbins, Hayek, and others, became the redoubt of traditional liberalism, battling to uphold the creed as socialism and Keynesianism became the dominant forces of the time. Hayek was at the forefront, not only the most consistent but indeed the most vocal critic of Keynes's work both before and after *The General Theory*. Keynes's approach, Hayek believed, was based on error; it would not solve the slump but would institutionalize inflation.

Indeed, in Hayek's view, *The General Theory* was not a general theory of economics at all but rather a dressed-up specific theory to get around a political impasse in Britain. Keynes was no less slashing in his rejoinders. Hayek, he said, had started in one article "with a mistake" and then proceeded to "bedlam." Another Hayek article, he said, was "the wildest farrago of nonsense." In 1933 Keynes wrote his wife about a visit that Hayek had made to Cambridge. Keynes sat next to him at dinner and then lunched with him the following day. "We get on very well in private life. But what rubbish his theory is."

As World War II progressed, Hayek became increasingly apprehensive about what he saw as the advance of collectivism, central planning, and what would become Keynesian interventionism. In one of his most famous articles, he argued that the problem of knowledge defeats central control of economies: Those at the center can never have enough information to make their decisions. Much better, he argued, was the price system, which, in "its real function" was "a mechanism for communicating information." For Hayek, it was nothing less than "a marvel." He explained, "The marvel is that in a case like that of a scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly; that is, they move in the right direction."

At the same time Hayek was preparing a full-scale broadside in a much more popular form—*The Road to Serfdom*. That book, which appeared in 1944, might have become a best-seller in Britain were it not for the extreme paper rationing of the war. Nevertheless, at least one copy found its way into the hands of an Oxford undergraduate, Margaret Roberts, not yet Margaret Thatcher. The University of Chicago Press published it in the United States, and Hayek's arguments went on to have much wider fame when *Reader's Digest* published a condensed version. To some degree, Hayek had to make his arguments in code, for it was not acceptable to criticize the Soviet Union, which at the time was a great ally. Even so, after World War II, the four-power-occupation authorities in Germany banned the book there at the behest of the Soviet Union.

Keynes, who read *The Road to Serfdom* while on his way to the Bretton Woods conference, wrote Hayek, more than oddly, that it was "a grand book." He added that he was in "deeply moved agreement" with the whole of it. He then proceeded to lay out his profound disagreement: "According to my ideas you greatly under-estimate the practicability of the middle course.... What we want is not no planning, or even less planning, indeed I should say that we almost certainly want more." He concluded by advising Hayek to take up "the restoration of right moral thinking." For "if only you could turn your crusade in that direction you would not feel quite so much like Don Quixote."

But after the initial splash of *The Road to Serfdom*, Hayek did rather seem a Don Quixote off on a fanciful campaign. In later years, Hayek would ruefully acknowledge that the book was too "popular" for his own academic good and had discredited him within the economics profession. The breakup of his first marriage occurred shortly after, and he married a woman he had first fallen in love with over 20 years earlier. In 1950, Hayek left LSE for an appointment at the University of Chicago. He was professor of social and moral sciences and a member of the prestigious Committee on Social Thought, where his colleagues included some of America's most stellar intellectuals. He was not part of the economics department and did not have much direct impact on students there. He struck people as very much an old-style

Central European gentleman—reserved, rather austere. When a young graduate student (much later a Nobel Prize winner) asked him to read a draft essay on economic analysis and political choice, Hayek politely declined. He did not read handwritten manuscripts, he explained.

It was while at Chicago that Hayek wrote what many consider his outstanding work, *The Constitution of Liberty*, published in 1960. In it, he further developed one of his most important themes: Laissez-faire was not enough. Government did have a clear role: to ensure the development and maintenance of the institutions—the laws and rules—that would ensure a competitive economy. And that, whatever emotion might otherwise say, remained the best mechanism for achieving the ideals that had captured him on the battlefield of World War I. Hayek never quite felt at home in Chicago. He kept a car in Paris, and whenever he could, he returned to the Alps with his new wife. Depression began to unsettle him. After a dozen years at the University of Chicago, he took up an appointment at the University of Freiburg, amid the Ordoliberals.

The Alps had already provided the venue from which Hayek would extend his influence. In 1947, he had taken the lead in convening a meeting of a remarkable group of intellectuals, mainly economists, numbering just 36. It was held at a Swiss spa on Mont Pelerin, and ever after became known as the Mont Pelerin Society. The first session was such a success that the group reconvened two years later and thereafter on a regular basis, in different locations, with ever-growing numbers. It provided a framework for like-minded thinkers to dissect socialism and collectivism and to debate and argue philosophy and policies. It also provided liberal (in the European sense) economists with the sense of an international community, with a fervor to develop their ideas, and—especially for those coming from countries where liberal economists were few and far between—the means to overcome their isolation and the comfort of knowing that they were not alone.

For Hayek, the meetings of the Mont Pelerin Society were essential bivouacs in the war of ideas. He believed that the struggle would be a long one; liberal thinking would be on the defensive "for the next 10 or 20 years, during which the present collectivist trend is bound to continue." In a paper entitled "The Intellectuals and Socialism," which he circulated after the first meeting of the society, he warned the participants that they should prepare for the protracted struggle, though it was one that they could win. "What to the contemporary observer appears as a battle of conflicting interests decided by the votes of the masses," he said, "has usually been decided long before in a battle of ideas confined to narrow circles."

The Abandoned Road

When the course of civilization takes an unexpected turn—when, instead of the continuous progress which we have come to expect, we find ourselves threatened by evils associated by us with past ages of barbarism—we naturally blame anything but ourselves. Have we not all striven according to our best lights, and have not many of our finest minds incessantly worked to make this a better world? Have not all our efforts and hopes been directed toward greater freedom, justice, and prosperity?

If the outcome is so different from our aims—if, instead of freedom and prosperity, bondage and misery stare us in the face—is it not clear that sinister forces must have foiled our intentions, that we are the victims of some evil power which must be conquered before we can resume the road to better things?

However much we may differ when we name the culprit—whether it is the wicked capitalist or the vicious spirit of a particular nation, the stupidity of our elders, or a social system not yet, although we have struggled against it for a half a century, fully overthrown—we all are, or at least were until recently, certain of one thing: that the leading ideas which during the last generation have become common to most people of good will and have determined the major changes in our social life cannot have been wrong.

We are ready to accept almost any explanation of the present crisis of our civilization except one: that the present state of the world may be the result of genuine error on our own part and that the pursuit of some of our most cherished ideals has apparently produced results utterly different from those which we expected....

That democratic socialism, the great utopia of the last few generations, is not only unachievable, but that to strive for-it produces something so utterly different that few of those who now wish it would be prepared to accept the consequences, many will not believe until the connection has been laid bare in all its aspects.

Individualism and Collectivism

Before we can progress with our main problem, an obstacle has yet to be surmounted. A confusion largely responsible for the way in which we are drifting into things which nobody wants must be cleared up. This confusion concerns nothing less than the concept of socialism itself. It may mean, and is often used to describe, merely the ideals of social justice, greater equality, and security, which are the ultimate aims of socialism. But it means also the particular method by which most socialists hope to attain these ends and which many competent people regard as the only methods by which they can be fully and quickly attained. In this sense socialism means the abolition of private enterprise, of private ownership of the means of production, and the creation of a system of "planned economy" in which the entrepreneur working for profit is replaced by a central planning body....

"Planning" owes its popularity largely to the fact that everybody desires, of course, that we should handle our common problems as rationally as possible and that, in so doing, we should use as much foresight as we can command. In this sense everybody who is not a complete fatalist is a planner, every political act is (or ought to be) an act of planning, and there can be differences only between good and bad, between wise and foresighted and foolish and shortsighted planning. An economist, whose whole task is the study of how men actually do and how they might plan their affairs, is the last person who could object to planning in this general sense. But it is not in this sense that our enthusiasts for a planned society now employ this term, nor merely in this sense that we must plan if we want the distribution of income or wealth to conform to some particular standard. According to the modern planners, and for their purposes, it is not sufficient to design the most rational permanent frame work within which the various activities would be conducted by different persons according to their individual plans. This liberal plan, according to them, is no plan—and it is, indeed, not a plan designed to satisfy particular views about who should have what. What our planners demand is a central direction of all economic activity according to a single plan, laying down how the resources of society should be "consciously directed" to serve particular ends in a definite way.

The dispute between the modern planners and their opponents is, therefore, not a dispute on whether we ought to choose intelligently between the various possible organizations of society; it is not a dispute on whether we ought to employ foresight and systematic thinking in planning our common affairs. It is a dispute about what is the best way of so doing. The question is whether for this purpose it is better that the holder of coercive power should confine himself in general to creating conditions under which the knowledge and initiative of individuals are given the best scope so that they can plan most successfully; or whether a rational utilization of our resources requires central direction and organization of all our activities according to some consciously constructed "blueprint." The socialists of all parties have appropriated the term "planning" for planning of the latter type, and it is now generally accepted in this sense. But though this is meant to suggest that this is the only rational way of handling our affairs, it does not, of course, prove this. It remains the point on which the planners and the liberals disagree.

It is important not to confuse opposition against this kind of planning with a dogmatic laissez-faire attitude. The liberal argument is in favor of making the best possible use of the forces of competition as a means of coordinating human efforts, not an argument for leaving things just as they are. It is based on the conviction that, where effective competition can be created, it is a better way of guiding individual efforts than any other. It does not deny, but even emphasizes, that, in order that competition should work beneficially, a carefully thought-out legal framework is required and that neither the existing nor the past legal rules are free from grave defects. Nor does it deny that, where it is impossible to create the conditions necessary to make competition effective, we must resort to other methods of guiding economic activity. Economic liberalism is opposed, however, to competition's being supplanted by inferior methods of coordinating individual efforts. And it regards competition as superior not only because it is in most circumstances the most efficient method known but even more because it is the only method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority. Indeed, one of the main arguments in favor of competition is that it dispenses with the need for "conscious social control" and that it gives the individuals a chance to decide whether the prospects of a particular occupation are sufficient to compensate for the disadvantages and risks connected with it.

The successful use of competition as the principle of social organization precludes certain types of coercive interference with economic life, but it admits of others which sometimes may very considerably assist its work and even requires certain kinds of government action. But there is good reason why the negative requirements, the points where coercion must not be used, have been particularly stressed. It is necessary in the first instance that the parties in the market should be free to sell and buy at any price at which they can find a partner to the transaction and that anybody should be free to produce, sell, and buy anything that may be produced or sold at all. And it is essential that the entry into the different trades should be open to all on equal terms and that the law should not tolerate any attempts by individuals or groups to restrict this entry by open or concealed force. Any attempt to control prices or quantities of particular commodities deprives competition of its power of bringing about an effective co-ordination of individual efforts, because price changes then cease to register all the relevant changes in circumstances and no longer provide a reliable guide for the individual's actions.

This is not necessarily true, however, of measures merely restricting the allowed methods of production, so long as these restrictions affect all potential producers equally and are not used as an indirect way of controlling prices and quantities. Though all such controls of the methods of production impose extra costs (i.e., make it necessary to use more resources to produce a given output), they may be well worth while. To prohibit the use of certain poisonous substances or to require special precautions in their use, to limit working hours or to require certain sanitary arrangements, is fully compatible with the preservation of competition. The only question here is whether in the particular instance the advantages gained are greater than the social costs which they impose. Nor is the preservation of competition incompatible with an extensive system of social services—so long as the organization of these services is not designed in such a way as to make competition ineffective over wide fields.

It is regrettable, though not difficult to explain, that in the past much less attention has been given to the positive requirements of a successful working of the competitive system than to these negative points. The functioning of a competition not only requires adequate organization of certain institutions like money, markets, and channels of information—some of which can never be adequately provided by private enterprise—but it depends, above all, on the existence of an appropriate legal system, a legal system designed both to preserve competition and to make it operate as beneficially as possible. It is by no means sufficient that the law should recognize the principle of private property and freedom of contract; much depends on the precise definition of the right of property as applied to different things. The systematic study of the forms of legal institutions which will make the competitive system work efficiently has been sadly neglected; and strong arguments can be advanced that serious shortcomings here, particularly with regard to the law of corporations and of patents, not only have made competition work much less effectively than it might have done but have even led to the destruction of competition in many spheres.

There are, finally, undoubted fields where no legal arrangements can create the main condition on which the usefulness of the system of competition and private property depends: namely, that the owner benefits from all the useful services rendered by his property and suffers for all the damages caused to others by its use. Where, for example, it is impracticable to make the enjoyment of certain services dependent on the payment of a price, competition will not produce the services; and the price system becomes similarly ineffective when the damage caused to others by certain uses of property cannot be effectively charged to the owner of that property. In all these instances there is a divergence between the items which enter into private calculation and those which affect social welfare; and, whenever this divergence becomes important, some method other than competition may have to be found to supply the services in question. Thus neither the provision of signposts on the roads nor, in most circumstances, that of the roads themselves can be paid for by every individual user. Nor can certain harmful effects of deforestation, of some methods of farming, or of the smoke and noise of factories be confined to the owner of the property in question or to those who are willing to submit to the damage for an agreed compensation. In such instances we must find some substitute for the regulation by the price mechanism. But the fact that we have to resort to the substitution of direct regulation by authority where the conditions for the proper working of competition cannot be created does not prove that we should suppress competition where it can be made to function.

To create conditions in which competition will be as effective as possible, to supplement it where it cannot be made effective, to provide the services which, in the words of Adam Smith, "though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals"—these tasks provide, indeed, a wide and unquestioned field for state activity. In no system that could be rationally defended would the state just do nothing. An effective competitive system needs an intelligently designed and continuously adjusted legal framework as much as any other. Even the most essential prerequisite of its proper functioning, the prevention of fraud and deception (including exploitation of ignorance), provides a great and by no means yet fully accomplished object of legislative activity.

Milton Friedman

(b. 1912)

Nobel Prize-winning economist Milton Friedman is widely regarded as the leader of the Chicago School of monetary economics, which stresses the importance of the quantity of money as an instrument of government policy and as a determinant of business cycles.

Winner of the Nobel Prize for Economics in 1976, Milton Friedman first aspired to become an insurance actuary. Despite his early love of mathematics, he failed several exams, however.

With the onset of the Great Depression, he turned his attention to economics and found his vocation. At the University of Chicago he steeped himself in the ideas of the classical laissez-faire economists. Work for the government followed and a Ph.D. from Columbia. In 1946 he returned to Chicago to teach, and there, over the next 30 years, he helped initiate a counterrevolution in economic thinking.

The prevailing economic wisdom of the day—Keynesianism—emphasized substantial central government planning and intervention in the marketplace. Friedman's early research convinced him that this approach was misguided. In 1947 he associated himself with conservative Austrian economist Friedrich Hayek, who was an outspoken opponent of all socialist policies. Friedman played a key role in the formation of Hayek's influential Mont Pelerin Society.

To Friedman, the quantity of money is the most important determinant in business cycles and inflation, and, accordingly, government should focus its attention on monetary policy rather than fiscal intervention in the marketplace. An outspoken advocate of both personal liberty and free markets, he has consistently argued for de-regulation and a reduced role for government overall.

Largely disregarded by America's mainstream power elite during the '50s and '60s, Friedman's star rose when some of the negative effects he had long predicted for Keynesian policies came true in the widespread economic "stagflation" of the 1970s.

Having advised conservative Arizona Senator Barry Goldwater in his unsuccessful 1964 presidential bid, he now found himself economic advisor to Presidents Nixon and Reagan, and to British Prime Minister Margaret Thatcher. In 1976 he moved from the University of Chicago to the Hoover Institute at Stanford in California.

Through books and a public television series in the 1980s, *Free to Choose,* Friedman has become widely known in America, but remains controversial. He was heavily criticized by liberals for his willingness to advise right-wing Chilean dictator Augusto Pinochet after Pinochet overthrew the democratically elected government of Salvador Allende. Unfazed, Friedman has argued that if he could help reestablish a free market in Chile, political freedom would eventually triumph there as well.

A protégé of the Chicago School and a leading monetarist, Milton Friedman was awarded the Nobel Prize in Economics in 1976 and has served as advisor to Presidents Nixon and Reagan.

This wide-ranging discussion moves from free-market economies to communism, covers the Great Depression and the New Deal, and offers Friedman's personal insights into Keynes, Hayek, Nixon, Reagan, and Pinochet.

On Freedom and Free Markets

INTERVIEWER: Why are free markets and freedom inseparable?

MILTON FRIEDMAN: Freedom requires individuals to be free to use their own resources in their own way, and modern society requires cooperation among a large number of people. The question is, how can you have cooperation without coercion? If you have a central direction you inevitably have coercion. The only way that has ever been discovered to have a lot of people cooperate together voluntarily is through the free market. And that's why it's so essential to preserving individual freedom.

INTERVIEWER: Marxists say that property is theft. Why, in your view, is private property so central to freedom?

MILTON FRIEDMAN: Because the only way in which you can be free to bring your knowledge to bear in your particular way is by controlling your property. If you don't control your property, if somebody else controls it, they're going to decide what to do with it, and you have no possibility of exercising influence on it. The interesting thing is that there's a lot of knowledge in this society, but, as Friedrich Hayek emphasized so strongly, that knowledge is divided. I have some knowledge; you have some knowledge; he has some knowledge. How do we bring these scattered bits of knowledge back together? And how do we make it in the self-interest of individuals to use that knowledge efficiently? The key to that is private property, because if it belongs to me, you know, there's an obvious fact. Nobody spends somebody else's money as carefully as he spends his own. Nobody uses somebody else's resources as carefully as he uses his own. So if you want efficiency and effectiveness, if you want knowledge to be properly utilized, you have to do it through the means of private property.

The Economic Logic Behind Black Markets

INTERVIEWER: Tell me why you can see the black market as a positive thing.

MILTON FRIEDMAN: Well, the black market was a way of getting around government controls. It was a way of enabling the free market to work. It was a way of opening up, enabling people. You want to trade with me, and the law won't let you. But that trade will be mutually beneficial to both of us. The most important single central fact about a free market is that no exchange takes place unless both parties benefit. The big difference between government coercion and private markets is that government can use coercion to make an exchange in which A benefits and B loses. But in the market, if A and B come to a voluntary agreement, it's because both of them are better off. And that's what the black market does, is to get around these artificial government restrictions. Now, obviously you'd like a world in which you obey the law. The fact that the black market involves breaking the law is something against it. It's an undesirable feature. But this only exists when there are bad laws. And nobody, nobody believes that obeying every law is an ultimate moral principle. There comes a point, if you look back at the history of law obedience—think of conscientious objection during wars—I think you will see that everybody agrees that there is a point at which there is a higher law than the legislative law.

On Friedrich Hayek and the Mont Pelerin Meeting

INTERVIEWER: Do you remember reading Hayek's *Road to Serfdom?* Did that have an impact on you?

MILTON FRIEDMAN: Yes, it certainly did have an impact. It was a very clear, definite statement of certain fundamental ideas. It was a passionate plea by a passionate man, and so it was very well written, and for those of us who were concerned about these kinds of issues, I think it had a tremendous impact. In fact, I've often gone around and asked people what determined their views. I've asked people who were in favor of free markets and free enterprise, people who formerly had been of a different view, what caused them to change their mind. I'm talking particularly not about economists, not about professionals, but generally ordinary people, most of whom had been socialist or in favor of government control at one time and had come over to free markets. And two names have come up over and over again: Hayek on the one hand, *The Road to Serfdom* from Hayek, and Ayn Rand on the other, *Atlas Shrugged* and her other books.

INTERVIEWER: You were invited to Friedrich Hayek's first Mont Pelerin meeting in 1947. Why?

MILTON FRIEDMAN: Well, I was invited primarily because of my brother-in-law, Aaron Director. He was an economist teaching [at] the University of Chicago, and when Hayek's *Road to Serfdom* was submitted to American publishers, one publisher after another rejected it. He was finally published by the University of Chicago Press, partly because of Aaron Director's intervention. He wasn't at Chicago at the time, he was in Washington, but he knew the director of the press, and he also was very close to Frank Knight, who was a professor at Chicago. And so Aaron had a considerable role in getting *The Road to Serfdom* published.

Also, he had studied at the London School of Economics and had met Hayek [there] before. One of the people whom Hayek was in touch with when he was exploring the possibilities of having the Mont Pelerin meeting was there. And so Aaron organized a group from the University of Chicago. There was myself, there was George Stigler, there was Frank Knight, and there was Aaron Director.

INTERVIEWER: What kind of people gathered at Mont Pelerin, and what was the point of the meeting?

MILTON FRIEDMAN: The point of the meeting was very clear. It was Hayek's belief, and the belief of other people who joined him there, that freedom was in serious danger. During the war, every country had relied heavily on government to organize the economy, to shift all production toward armaments and military purposes. And you came out of the war with the widespread belief that the war had demonstrated that central planning would work. It reinforced the lesson that had earlier been driven home, supposedly, by Russia. The left in particular, or the intellectuals in general in Britain and the United States, in France, wherever, had interpreted Russia as a successful experiment in central planning. And so there were strong movements everywhere. In Britain a socialist [Clement Attlee] had won the election. In France there was indicative planning that was [in] development. And so everywhere, Hayek and others felt that freedom was very much imperiled, that the world was turning toward planning and that somehow we had to develop an intellectual current that would offset that movement. This was the theme of *The Road to Serfdom.* Essentially, the Mont Pelerin Society was an attempt to offset *The Road to Serfdom,* to start a movement, a road to freedom as it were. Now, who were the people who were there? There were economists, historians, mostly economists and historians, but a few journalists and businessmen, people who, despite the general intellectual current moving towards socialism, had retained the belief in free markets and in political and economic freedom. They were those people whom Hayek happened to know, or whom he had met, whom he had run into in the course of his travels.

INTERVIEWER: What was Hayek's role at these meetings, and what was he like personally? This must have been the first time you met him.

MILTON FRIEDMAN: No, I had met him before that. I had met him in Chicago when he was in the United States lecturing on *The Road to Serfdom.* Hayek's role? Number one, he was responsible for the meeting. He organized it. He selected the people who were going to be there. He helped to line up some of the money that was used to finance it, though a considerable part of that came from a Swiss source. That's why it was held in Switzerland. So far as his role at the meetings was concerned, he gave a talk at the opening session which set out what he had in mind. Along with several other people, he set up the agenda and presided over some of the sessions, participated in the debates, and was a very effective participant from beginning to end.

INTERVIEWER: Some of those debates became very, very heated. I think [Ludwig] von Mises once stormed out.

MILTON FRIEDMAN: Oh, yes, he did. Yes, in the middle of a debate on the subject of distribution of income, in which you had people who you would hardly call socialist or egalitarian—people like Lionel Robbins, like George Stigler, like Frank Knight, like myself—Mises got up and said, "You're all a bunch of socialists," and walked right out of the room. (laughs) But Mises was a person of very strong views and rather intolerant about any differences of opinion.

INTERVIEWER: What was Hayek's personal style? What was he like personally?

MILTON FRIEDMAN: Oh, personally Hayek was a lovely man, a pure intellectual. He was seriously interested in the truth and in understanding. He differed very much in this way from Mises. There was none of that same kind of manner. He accepted disagreement and wanted to argue, wanted to reason about it and discuss it. He was a very cultured and delightful companion on any occasion. ... I must say, he undoubtedly was the dominant figure in all of the Mont Pelerin meetings for many, many years.

On John Maynard Keynes

INTERVIEWER: What impact did John Maynard Keynes have on you?

MILTON FRIEDMAN: Well, I read his book, of course, *The General Theory of Employment, Interest, and Money,* as everybody else did. I may say I had earlier read a good deal of Keynes. In fact, in my opinion, one of the best books he wrote was published in 1924 I believe, *A Tract on Monetary Reform,* which I think is really, in the long run, fundamentally better than *The General Theory,* which came much later. And so I was exposed to Keynes as a graduate student, and his *General Theory* was in the air. Everybody was talking about it. It was part of the general atmosphere.

It was when I went back and looked at some memos that I had written while I was working at the Treasury that I discovered how much more Keynesian I was than I thought. (amused) So what was his influence on me? It was, as on everybody else, to emphasize fiscal policy as opposed to monetary policy, and in particular to pay relatively little attention to the quantity of money as opposed to the interest rate.

INTERVIEWER: On a personal level, what contact did you have with him?

MILTON FRIEDMAN: With Keynes? The only contact I had with him was to submit an article to the *Economic Journal,* which he was editor of, which he refused and rejected. I had no personal contact with him other than that.

INTERVIEWER: What did the rejection say?

MILTON FRIEDMAN: Well, it was an article that was critical of something that A.C. Pigou, a professor in London and at Cambridge, had written. And Keynes wrote back that he had shown my article to Pigou. Pigou did not agree with the criticism, and so he had decided to reject it. The article was subsequently published by the *Quarterly Journal of Economics,* and Pigou wrote a rejoinder to it.

INTERVIEWER: When did you begin to break with Keynes and why? What were the first doubts you had?

MILTON FRIEDMAN: Very shortly after the war, when I came to the University of Chicago and started working on money and its relation to the economic cycle. I cannot tell you exactly when, but very shortly thereafter, as I studied the facts, they seemed to me to contradict what Keynesian theory would call for.

INTERVIEWER: What was it that you studied that made you begin to feel that this didn't add up?

MILTON FRIEDMAN: Let me emphasize [that] I think Keynes was a great economist. I think his particular theory in *The General Theory of Employment, Interest, and Money* is a fascinating theory. It's a right kind of a theory. It's one which says a lot by using only a little. So it's a theory that has great potentiality.

And you know, in all of science, progress comes through people proposing hypotheses which are subject to test and rejected and replaced by better hypotheses. And Keynes's theory, in my opinion, was one of those very productive hypotheses—a very ingenious one, a very intelligent one. It just turned out to be incompatible with the facts when it was put to the test. So I'm not criticizing Keynes. I am a great admirer of Keynes as an economist, much more than on the political level. On the political level, that's a different question, but as an economist, he was brilliant and one of the great economists.

Now the crucial issue is, which is more important in determining the short-run course of the economy? What happens to investment on the one hand, or what happens to the quantity of money on the other hand? What happens to fiscal policy on the one hand, or what happens to monetary policy on the other hand? And the facts that led me to believe that his hypothesis was not correct was that again and again it turned out that what happened to the quantity of money was far more important than what was happening to investments. The essential difference between the Keynesian theory and the pre-Keynesian, or the monetarist theory, as it was developed, is whether what's important to understanding the short-run movements of the economy is the relation between the flow of investments—the amount of money being spent on new investments, on the one hand, or the flow of money, the quantity of money in the economy and what's happening to it. By the quantity of money I just mean the cash that people count, carry around in their pockets and the deposits that they have in banks on which they can write checks. That's the quantity of money. And the quantity of money is controlled by monetary policy. On the investment side the flow of investment is controlled by private individuals, but is also affected by fiscal policy, by government taxing and government spending. The essential Keynesian argument, the basic Keynesian argument, was that the way to affect what happened to the economy as a whole, not to a particular part of it, but to the level of income, of employment and so on, was through fiscal policy, through changing government taxes and spending. The argument from the monetarists' side was that what was more important was what was happening to the quantity of money, monetary policy on that side. And so, as I examined the facts about these phenomena, it more and more became clear that what was important was the flow of money as compared to the flow of government spending, and when fiscal policy and monetary policy went in the same direction, you couldn't tell which was more important. But if you looked at those periods when fiscal policy went in one direction and monetary policy went in another direction, invariably it was what happened to monetary policy that determined matters. The public event that changed the opinion of the profession and of people at large was the stagflation of the 1970s, because under the Keynesian view, that was a period in which you had a very expansive fiscal policy, in which you should have had a great expansion in the economy. And instead you had two things at the same time, which under the Keynesian view would have been impossible: You had stagnation in the economy, a high level of unemployment. You had inflation with prices rising rapidly. We had predicted in advance that that would be what happened, and when it happened, it was very effective in leading people to believe that, maybe, there was something to what before had been regarded as utter nonsense.

INTERVIEWER: Was stagflation the end for Keynesianism?

MILTON FRIEDMAN: Stagflation was the end of naive Keynesianism. Now obviously the term "Keynesian" can mean anything you want it to mean, and so you have new Keynesianism, but this particular feature was put to an end by the stagflation episode.

INTERVIEWER: Talking about Keynesian policies, John Kenneth Galbraith, when we talked to him a few days ago, said that World War II "affirmed Keynes and his policies." Do you agree?

MILTON FRIEDMAN: No, I don't agree at all. World War II affirmed what everybody knew for a long time. If you print enough money and spend it you can create an appearance of activity and prosperity. That's what it confirmed. It did not confirm his theories about how you preserve full employment over a long time.

The Great Depression

INTERVIEWER: You've written that what really caused the Depression was mistakes by the government. Looking back now, what in your view was the actual cause?

MILTON FRIEDMAN: Well, we have to distinguish between the recession of 1929, the early stages, and the conversion of that recession into a major catastrophe. The recession was an ordinary business cycle. We had repeated recessions over hundreds of years, but what converted [this one] into a major depression was bad monetary policy. The Federal Reserve system had been established to prevent what actually happened. It was set up to avoid a situation in which you would have to close down banks, in which you would have a banking crisis. And yet, under the Federal Reserve system, you had the worst banking crisis in the history of the United States. There's no other example I can think of, of a government measure which produced so clearly the opposite of the results that were intended. And what happened is that [the Federal Reserve] followed policies which led to a decline in the quantity of money by a third. For every $100 in paper money, in deposits, in cash, in currency, in existence in 1929, by the time you got to 1933 there was only about $65, $66 left. And that extraordinary collapse in the banking system, with about a third of the banks failing from beginning to end, with millions of people having their savings essentially washed out, that decline was utterly unnecessary. At all times, the Federal Reserve had the power and the knowledge to have stopped that. And there were people at the time who were all the time urging them to do that. So it was, in my opinion, clearly a mistake of policy that led to the Great Depression.

INTERVIEWER: How did the Depression change your life and your career plans? You started out [with plans] to become an insurance actuary; instead you became an economist.

MILTON FRIEDMAN: Well, I don't think that's very hard to understand. It's 1932. Twenty-five percent of the American working force is unemployed. My major problem with the world is a problem of scarcity in the midst of plenty ... of people starving while there are unused resources ... people having skills which are not being used. If you're a 19-year-old college senior, which is going to be more important to you: figuring out what the right prices ought to be for life insurance, or trying to understand how the world got into that kind of a mess?

Why are you not, and why have you never been, a communist?

INTERVIEWER: A lot of people in the '30s were drawn to the left. So why are you not and why have you never been a communist?

MILTON FRIEDMAN: (laughs) No, I've not, never been a communist. Never even been a socialist—[though] it may well be that I harbored socialist thoughts at the time when I was an undergraduate. But undoubtedly [the fact that I'm not a communist] is tied in with the accident that I went to the University of Chicago for graduate study and at the department of economics at the University of Chicago, they were classical liberal economists. Classical economics, which begins with Adam Smith, with his book *The Wealth of Nations,* published in 1776, the same year as the American Revolution and the American Declaration of Independence, emphasizes the individual as the ultimate objective of science. And the question of economic science is how to explain the way in which individuals interact with one another, to use their limited resources to satisfy their alternative ends. The emphasis is on the fact that there are many objectives that people have. There are limited resources to satisfy them. What's the mechanism whereby you decide which ends are to be satisfied for which people in what way? And the emphasis in the classical liberal economists is on doing that through free markets.

Did you support Franklin Roosevelt's New Deal?

INTERVIEWER: Now at the time of the Depression, did you personally support New Deal policies?

MILTON FRIEDMAN: You're now talking not about the Depression, but the post-Depression. At least the bottom of the Depression was in 1933. You have to distinguish between two classes of New Deal policies. One class of New Deal policies was reform: wage and price control, the Blue Eagle, the national industrial recovery movement. I did not support those. The other part of the new deal policy was relief and recovery... providing relief for the unemployed, providing jobs for the unemployed, and motivating the economy to expand... an expansive monetary policy. Those parts of the New Deal I did support.

INTERVIEWER: But why did you support those?

MILTON FRIEDMAN: Because it was a very exceptional circumstance. We'd gotten into an extraordinarily difficult situation, unprecedented in the nation's history. You had millions of people out of work. Something had to be done; it was intolerable. And it was a case in which, unlike most cases, the short run deserved to dominate. I want to emphasize that you're talking about a long time ago. I was very young and unsophisticated, inexperienced, and I can't swear to you that what I'm saying now is actually what I believed then. I don't have any record of what my specific attitude was toward the New Deal policies. I must confess that probably I was thinking at that time more about my own interests and position than I was about these broader issues. So I think this is somewhat retrospective thinking rather than thinking at the time.

On Richard Nixon

MILTON FRIEDMAN: Nixon was the most socialist of the presidents of the United States in the 20th century.

INTERVIEWER: I've heard Nixon accused of many things, but never [of being] a socialist before.

MILTON FRIEDMAN: Well, his ideas were not socialist, quite the opposite, but if you look at what happened during his administration, first of all, the number of pages in the Federal Register, which is full of regulations about business, doubled during his regime. During his regime the EPA, the Environmental Protection Agency, was established and the OSHA, the Occupational Safety and Health Administration, the OECA [the Office of Enforcement and Compliance Assurance of the EPA]—about a dozen, a half-dozen alphabetic agencies were established so that you had the biggest increase in government regulation and control of industry during the Nixon administration that you had in the whole postwar period.

INTERVIEWER: Tell us how Nixon decided to adopt wage and price controls.

MILTON FRIEDMAN: Nixon, as you know, had been in the price control organization during World War II and understood that price controls were a very bad idea, and so he was strongly opposed to price controls. And yet, in 1971, August 15, 1971, he adopted wage and price controls. And the reason he did it, in my opinion, was because of something else that was happening, and that had to do with the exchange rate; that had to do with Bretton Woods and the agreement to peg the price of gold. The United States had agreed in 1944, at the Bretton Woods Conference, on an international financial system under which other countries would link their currencies to the U.S. dollar, and the United States would link its currency to gold and keep the price of gold at $35 an ounce. And because of the policies that were followed by the Kennedy and Johnson administrations, it had become very difficult to do that. We had had inflationary policies, which led to a tendency for the gold to flow out, for the price of gold to go above $35 an ounce. And the situation had become very critical in 1971. Nixon had to do something about that. If he had done nothing but close the gold window, if he had said the United States is going off the gold standard and done nothing else, every headline in every newspaper would have been, "That negative Nixon again! Just a negative act." And so instead he dressed it up by making it part of a general economic policy, a recovery policy, in which wage and price controls, which the democrats had been urging all along, became a major element. And by putting together the combination of closing the gold window and at the same time having wage and price controls, he converted what would have been a negative from a political point of view to a political positive. And that was the political reason for which he did it.

INTERVIEWER: There is a photograph of you and George Shultz with Nixon in the Oval Office. What did you say to him on that occasion? What did you tell him?

MILTON FRIEDMAN: Well, I don't know what occasion that particular one was, but the one that's relevant to your question is the last time I saw Nixon in the Oval Office with George Shultz. What we usually discussed when Nixon wanted to talk was the state of the economy: what monetary policy was doing.

Nixon was a very, very smart person. In fact, he had one of the highest IQs of any public official I've met. The problem with Nixon was not intelligence and not prejudices. The problem with him was that he was willing to sacrifice principles too easily for political advantage. But at any rate, as I was getting up to leave, President Nixon said to me, "Don't blame George for this silly business of wage and price controls," meaning George Shultz. And I believe I said to him, I think I said to him, "Oh, no, Mr. President. I don't blame George; I blame you! " (laughs) And that, I think, was the last thing I said to him. Now, the interesting point of that story is that the Nixon tapes are now available, and I have been trying to get that part of the Nixon tapes, but I haven't been able to get them yet. I want to make sure I didn't make this up.

On Ronald Reagan

INTERVIEWER: Tell us briefly how Paul Volcker set out to squeeze inflation out of the economy.

MILTON FRIEDMAN: Well, by the time Paul Volcker came along—this was in 1968-69 [Volcker was undersecretary in the Treasury Department from 1969-74, president of the New York Federal Reseve Bank from 1975-79, and appointed chairman of the Board of Governors of the Federal Reserve Board from 1979-87]—inflation had gotten very high and had gone up close to 20 percent. He was at a meeting of the International Monetary Fund in Yugoslavia in 1979, when the U.S. came under great criticism from the other people there for our inflationary policies. And he came back to the United States and had got the open market committee to announce that they would change their policy and shift from controlling interest rates to controlling the quantity of money. Now, this was mostly verbal rhetoric. What he really wanted to do was to have the interest rate go up very high, to reflect the amount of inflation.

But he could do it better by professing that he wasn't controlling it and that he was controlling the quantity of money, and the right policy at that time was to limit what was happening to the quantity of money, and that meant the interest rate shot way up. This is a complex story. It isn't all one way, because in early 1980 President Carter introduced controls on installment spending, and that caused a very sharp collapse in the credit market and caused a very sharp downward spiral in the economy. To counter that, the Federal Reserve increased the money supply very rapidly. In the five months before the 1980 election, the money supply went up more rapidly than in any other five-month period in the postwar era. Immediately after him, Reagan was elected, and the money supply started going down. So that was a very political reaction during that period.

INTERVIEWER: How important was President Reagan's support for Volcker's policies?

MILTON FRIEDMAN: Enormously important. There is no other president in the postwar period who would have stood by without trying to interfere, to intervene with the Federal Reserve. The situation was this: The only way you could get the inflation down was by having monetary contraction. There was no way you could do that without having a temporary recession. The great error in the earlier period had been that whenever there was a little contraction there was a tendency to expand the money supply rapidly in order to avoid unemployment. That stop-and-go policy was really what bedeviled the Fed during the '60s and '70s. That was the situation in 1980, in '81 in particular. After Reagan came into office, the Fed did step on the money supply, did hold down its growth, and that did lead to a recession. At that point every other president would have immediately come in and tried to get the Federal Reserve to expand. Reagan knew what was happening. He understood very well that the only way he could get inflation down was by accepting a temporary recession, and he supported Volcker and did not try to intervene. Now, you know, there is a myth that Reagan was somehow simpleminded and didn't understand these things. That's a bunch of nonsense. He understood this issue very well. And I know— I can speak with, I think, authority on this—that he realized what he was doing, and he knew very well that he was risking his political standing in order to achieve a basic economic objective. And, as you know, his poll ratings went way down in 1982, and then, when the inflation seemed to be broken enough, the Fed reversed policy, started to expand the money supply, the economy recovered, and along with it, Reagan's poll ratings went back up.

INTERVIEWER: And the economy has been pretty solid ever since. [As of the year 2000.]

MILTON FRIEDMAN: Yes, absolutely. There is no doubt in my mind that that action of Reagan, plus his emphasis on lowering tax rates, plus his emphasis on deregulating ... I mentioned that the regulations had doubled, the number of pages in the Federal Register had doubled, during the Nixon regime; they almost halved during the Reagan regime. So those actions of Reagan unleashed the basic constructive forces of the free market and from 1983 on, it's been almost entirely up.

INTERVIEWER: What Reagan was doing is almost exactly mirrored in Britain by what Mrs. Thatcher was doing at about the same time. Are the two influencing to each other, or is it just a case of ideas coming into their own?

MILTON FRIEDMAN: Both of them faced similar situations. And both of them, fortunately, had exposure to similar ideas. And they reinforced one another. Each saw the success of the other. I think that the coincidence of Thatcher and Reagan having been in office at the same time was enormously important for the public acceptance, worldwide, of a different approach to economic and monetary policy.

On His Role in Chile Under Pinochet

INTERVIEWER: Tell us about some of the abuse you had to suffer and the degree to which you were seen as a figure out on the fringes.

MILTON FRIEDMAN: Well, I wouldn't call it abuse, really. (laughs) I enjoyed it. The only thing I would call abuse was in connection with the Chilean episode, when Allende was thrown out in Chile, and a new government came in that was headed by Pinochet. At that time, for an accidental reason, the only economists in Chile who were not tainted with the connection to Allende were a group that had been trained at the University of Chicago, who got to be known as the Chicago Boys. And at one stage I went down to Chile and spent five days there with another group—there were three or four of us from Chicago—giving a series of lectures on the Chilean problem, particularly the problem of inflation and how they should proceed to do something about it. The communists were determined to overthrow Pinochet. It was very important to them, because Allende's regime, they thought, was going to bring a communist state in through regular political channels, not by revolution. And here, Pinochet overthrew that. They were determined to discredit Pinochet. As a result, they were going to discredit anybody who had anything to do with him. And in that connection, I was subject to abuse in the sense that there were large demonstrations against me at the Nobel ceremonies in Stockholm. I remember seeing the same faces in the crowd in a talk in Chicago and a talk in Santiago. And there was no doubt that there was a concerted effort to tar and feather me.

INTERVIEWER: It seems to us that Chile deserves a place in history because it's the first country to put Chicago theory into practice. Do you agree?

MILTON FRIEDMAN: No, no, no. Not at all. After all, Great Britain put Chicago theory in practice in the 19th century. (amused) The United States put the Chicago theory in practice in the 19th and 20th century. I don't believe that's right.

INTERVIEWER: You don't see Chile as a small turning point, then?

MILTON FRIEDMAN: It may have been a turning point, but not because it was the first place to put the Chicago theory in practice. It was important on the political side, not so much on the economic side. Here was the first case in which you had a movement toward communism that was replaced by a movement toward free markets. See, the really extraordinary thing about the Chilean case was that a military government followed the opposite of military policies. The military is distinguished from the ordinary economy by the fact that it's a top-down organization. The general tells the colonel, the colonel tells the captain, and so on down, whereas a market is a bottom-up organization. The customer goes into the store and tells the retailer what he wants; the retailer sends it back up the line to the manufacturer and so on. So the basic organizational principles in the military are almost the opposite of the basic organizational principles of a free market and a free society. And the really remarkable thing about Chile is that the military adopted the free-market arrangements instead of the military arrangements.

INTERVIEWER: When you were down in Chile you spoke to some students in Santiago. In your own words, can you tell me about that speech in Santiago?

MILTON FRIEDMAN: Sure. While I was in Santiago, Chile, I gave a talk at the Catholic University of Chile. Now, I should explain that the University of Chicago had had an arrangement for years with the Catholic University of Chile, whereby they send students to us and we send people down there to help them reorganize their economics department. And I gave a talk at the Catholic University of Chile under the title "The Fragility of Freedom." The essence of the talk was that freedom was a very fragile thing and that what destroyed it more than anything else was central control; that in order to maintain freedom, you had to have free markets, and that free markets would work best if you had political freedom. So it was essentially an anti-totalitarian talk. (amused)

INTERVIEWER: So you envisaged, therefore, that the free markets ultimately would undermine Pinochet?

MILTON FRIEDMAN: Oh, absolutely. The emphasis of that talk was that free markets would undermine political centralization and political control. And incidentally, I should say that I was not in Chile as a guest of the government. I was in Chile as the guest of a private organization.

INTERVIEWER: Do you think the Chile affair damaged your reputation, or more importantly, made it harder for you to get your ideas across?

MILTON FRIEDMAN: That's a very hard thing to say, because I think it had effects in both directions. It got a lot of publicity. It made a lot of people familiar with the views who would not otherwise have been. On the other hand, in terms of the political side of it, as you realize, most of the intellectual community, the intellectual elite, as it were, were on the side of Allende, not on the side of Pinochet. And so in a sense they regarded me as a traitor for having been willing to talk in Chile. I must say, it's such a wonderful example of a double standard, because I had spent time in Yugoslavia, which was a communist country. I later gave a series of lectures in China. When I came back from communist China, I wrote a letter to the Stanford Daily newspaper in which I said, '"It's curious. I gave exactly the same lectures in China that I gave in Chile. I have had many demonstrations against me for what I said in Chile. Nobody has made any objections to what I said in China. How come?"

INTERVIEWER: In the end, the Chilean [economy] did quite well, didn't it?

MILTON FRIEDMAN: Oh, very well. Extremely well. The Chilean economy did very well, but more important, in the end the central government, the military junta, was replaced by a democratic society. So the really important thing about the Chilean business is that free markets did work their way in bringing about a free society.

Where We Stand Today

INTERVIEWER: From your apartment, you can almost see Silicon Valley. How do you think information technology, the Internet, and the new economy, will affect the big issues of economics and politics that you've devoted your life to?

MILTON FRIEDMAN: The most important ways in which I think the Internet will affect the big issue is that it will make it more difficult for government to collect taxes. And I think that's a very important factor. Governments can most effectively collect taxes on things that can't move. That's why property taxes are invariably the first tax. People can move, so it's a little more difficult to collect taxes on them. States within the United States find it more difficult to collect taxes on people, but the United States as a whole can collect taxes on people more easily. Now the Internet, by enabling transactions to be made in cyberspace, not recorded, by enabling them to move so that somebody in Britain can order books from Amazon.com in the United States, somebody in the United States can do a deal in India, I think the cyberspace is going to make it very much more difficult for government to collect taxes, and that will have a very important effect on reducing the role that governments can play.

INTERVIEWER: So we're sort of marching forward to a kind of, the ultimate "Hayekian" state, are we?

MILTON FRIEDMAN: I think we are in that respect. Now, of course it has its advantages and disadvantages. It makes it easier for criminals to conduct their affairs, but, you know, you have to distinguish between criminals and criminals. We have as many criminals as we have because we have as many laws to break as we have. You take the situation in the United States. We have two million people in prison, four million people who are under parole or under supervision. Why? Because of our mistaken attempt to control what people put in their bodies. Prohibition of so-called drugs, of illegal drugs, is a major reason for all of those prisons. And those are victimless crimes, which should not be crimes.

INTERVIEWER: More than half a century after that first meeting in Mont Pelerin, who's won the argument? Who's lost?

MILTON FRIEDMAN: There is no doubt who won the intellectual argument. There is no doubt that the received intellectual opinion of the world today is much less favorable towards central planning and controls than it was in 1947. What's much more dubious is who won the practical argument. The world is more socialist today than it was in 1947. Government spending in almost every Western country is higher today than it was in 1947, as a fraction of income, not simply in dollars. Government regulation of business is larger. There has not been a great deal of nationalization, socialization in that sense, but government intervention in the economy has undoubtedly gone up. The only countries where that is not true are the countries which were formerly part of the communist system. You can see that we won the argument in practice as well as on the intellectual level in Poland, in Czechoslovakia, in Hungary, in Russia, and throughout that part of the world. But in the West, the practical argument is as yet undecided.

INTERVIEWER: Are you hopeful?

MILTON FRIEDMAN: Oh, yes, I'm very hopeful about it. Don't misunderstand me. At the moment we have not won the argument in practice, but I think in the long run ideas will dominate, and I think we will win the argument in practice as well as on the intellectual level.

INTERVIEWER: Central controls have been discredited, the governments seem to have retreated remarkably, but are we becoming increasingly regulated?

MILTON FRIEDMAN: You have to distinguish different areas. Some kinds of regulations have declined. Regulations of prices, particular regulations of industries as a whole have declined. Other kinds of regulations, particularly regulations on personal behavior, have gone up. It's social control that has been taking the place of narrow economic control.

INTERVIEWER: Do you feel some of those regulations are ultimately a threat to the free market?

MILTON FRIEDMAN: They're not a threat to the free market. They're a threat to human freedom.

INTERVIEWER: At the moment, governments everywhere are retreating from the marketplace, or seem to be. Do you think a pendulum could swing back the other way?

MILTON FRIEDMAN: The pendulum easily can swing back the other way. It can swing back the other way, not because anybody wants to do it in a positive sense, but simply because as long as you have governments which control a great deal of power, there always [will be] pressure from special interests to intervene. And once you get something in government, it's very hard to get it out. So I think there is a real danger. I don't think we can regard the war as won by any manner of means. I think it still is true that it takes continued effort to keep a society free. What's the saying? "Eternal vigilance is the price of liberty."