INTRODUCTION

Ever since the first settlement of Europeans in the New World America has been a magnet for people seeking adventure, fleeing from tyranny, or simply trying to make a better life for themselves and their children.

An initial trickle swelled after the American Revolution and the establishment of the United States of America and became a flood in the nineteenth century, when millions of people streamed across the Atlantic, and a smaller number across the Pacific, driven by misery and tyranny, and attracted by the promise of freedom and affluence.

When they arrived, they did not find streets paved with gold; they did not find an easy life. They did find freedom and an opportunity to make the most of their talents. Through hard work, ingenuity, thrift, and luck, most of them succeeded in realizing enough of their hopes and dreams to encourage friends and relatives to join them.

The story of the United States is the story of an economic miracle and a political miracle that was made possible by the translation into practice of two sets of ideas—both, by a curious coincidence, formulated in documents published in the same year, 1776.

One set of ideas was embodied in *The Wealth of Nations*, the masterpiece that established the Scotsman Adam Smith as the father of modern economics. It analyzed the way in which a market system could combine the freedom of individuals to pursue their own objectives with the extensive cooperation and collaboration needed in the economic field to produce our food, our clothing, our housing. Adam Smith's key insight was that both parties to an exchange can benefit and that, *so long as cooperation is strictly voluntary*, no exchange will take place unless both parties do benefit. No external force, no coercion, no violation of freedom is necessary to produce cooperation among individuals all of whom can benefit. That is why, as Adam Smith put it, an individual who "intends only his own gain" is "led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good." [1]

The second set of ideas was embodied in the Declaration of Independence, drafted by Thomas Jefferson to express the general sense of his fellow countrymen. It proclaimed a new nation, the first in history established on the principle that every person is entitled to pursue his own values: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights; that among these are Life, Liberty, and the pursuit of Happiness."

Or, as stated in more extreme and unqualified form nearly a century later by John Stuart Mill,

> The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is self protection. . . . [T]he only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant. . . . The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.[2]

Much of the history of the United States revolves about the attempt to translate the principles of the Declaration of Independence into practice—from the struggle over slavery, finally settled by a bloody civil war, to the subsequent attempt to promote equality of opportunity, to the more recent attempt to achieve equality of results.

Economic freedom is an essential requisite for political freedom. By enabling people to cooperate with one another without

coercion or central direction, it reduces the area over which political power is exercised. In addition, by dispersing power, the free market provides an offset to whatever concentration of political power may arise. The combination of economic and political *power* in the same hands is a sure recipe for tyranny.

The combination of economic and political *freedom* produced a golden age in both Great Britain and the United States in the nineteenth century. The United States prospered even more than Britain. It started with a clean slate: fewer vestiges of class and status; fewer government restraints; a more fertile field for energy, drive, and innovation; and an empty continent to conquer.

The fecundity of freedom is demonstrated most dramatically and clearly in agriculture. When the Declaration of Independence was enacted, fewer than 3 million persons of European and African origin (i.e., omitting the native Indians) occupied a narrow fringe along the eastern coast. Agriculture was the main economic activity. It took nineteen out of twenty workers to feed the country's inhabitants and provide a surplus for export in exchange for foreign goods. Today it takes fewer than one out of twenty workers to feed the 220 million inhabitants and provide a surplus that makes the United States the largest single exporter of food in the world.

What produced this miracle? Clearly not central direction by government—nations like Russia and its satellites, mainland China, Yugoslavia, and India that today rely on central direction employ from one-quarter to one-half of their workers in agriculture, yet frequently rely on U.S. agriculture to avoid mass starvation. During most of the period of rapid agricultural expansion in the United States the government played a negligible role. Land was made available—but it was land that had been unproductive before. After the middle of the nineteenth century land-grant colleges were established, and they disseminated information and technology through governmentally financed extension services. Unquestionably, however, the main source of the agricultural revolution was private initiative operating in a free market open to all—the shame of slavery only excepted. And the most rapid growth came after slavery was abolished. The millions of immigrants from all over the world were free to work for themselves, as independent farmers or businessmen, or to work for others, at terms mutually agreed. They were free to experiment with new techniques—at their risk if the experiment failed, and to their profit if it succeeded. They got little assistance from government. Even more important, they encountered little interference from government.

Government started playing a major role in agriculture during and after the Great Depression of the 1930s. It acted primarily to restrict output in order to keep prices artificially high.

The growth of agricultural productivity depended on the accompanying industrial revolution that freedom stimulated. Thence came the new machines that revolutionized agriculture. Conversely, the industrial revolution depended on the availability of the manpower released by the agricultural revolution. Industry and agriculture marched hand in hand.

Smith and Jefferson alike had seen concentrated government power as a great danger to the ordinary man; they saw the protection of the citizen against the tyranny of government as the perpetual need. That was the aim of the Virginia Declaration of Rights (1776) and the United States Bill of Rights (1791); the purpose of the separation of powers in the U.S. Constitution; the moving force behind the changes in the British legal structure from the issuance of the Magna Carta in the thirteenth century to the end of the nineteenth century. To Smith and Jefferson, government's role was as an umpire, not a participant. Jefferson's ideal, as he expressed it in his first inaugural address (1801), was "[a] wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement."

Ironically, the very success of economic and political freedom reduced its appeal to later thinkers. The narrowly limited government of the late nineteenth century possessed little concentrated power that endangered the ordinary man. The other side of that coin was that it possessed little power that would enable good people to do good. And in an imperfect world there were still many evils. Indeed, the very progress of society made the residual evils seem all the more objectionable. As always, people took the favorable developments for granted. They forgot the danger to freedom from a strong government. Instead, they were attracted by the good that a stronger government could achieve—if only government power were in the "right" hands.

These ideas began to influence government policy in Great Britain by the beginning of the twentieth century. They gained increasing acceptance among intellectuals in the United States but had little effect on government policy until the Great Depression of the early 1930s. As we show in Chapter 3, the depression was produced by a failure of government in one area—money—where it had exercised authority ever since the beginning of the Republic. However, government's responsibility for the depression was not recognized—either then or now. Instead, the depression was widely interpreted as a failure of free market capitalism. That myth led the public to join the intellectuals in a changed view of the relative responsibilities of individuals and government. Emphasis on the responsibility of the individual for his own fate was replaced by emphasis on the individual as a pawn buffeted by forces beyond his control. The view that government's role is to serve as an umpire to prevent individuals from coercing one another was replaced by the view that government's role is to serve as a parent charged with the duty of coercing some to aid others.

These views have dominated developments in the United States during the past half-century. They have led to a growth in government at all levels, as well as to a transfer of power from local government and local control to central government and central control. The government has increasingly undertaken the task of taking from some to give to others in the name of security and equality. One government policy after another has been set up to "regulate" our "pursuits of industry and improvement," standing Jefferson's dictum on its head (Chapter 7).

These developments have been produced by good intentions with a major assist from self-interest. Even the strongest supporters of the welfare and paternal state agree that the results have been disappointing. In the government sphere, as in the market, there seems to be an invisible hand, but it operates in precisely the opposite direction from Adam Smith's: an individual who intends only to serve the public interest by fostering government intervention is "led by an invisible hand to promote" private interests, "which was no part of his intention." That conclusion is driven home again and again as we examine, in the chapters that follow, the several areas in which government power has been exercised—whether to achieve security (Chapter 4) or equality (Chapter 5), to promote education (Chapter 6), to protect the consumer (Chapter 7) or the worker (Chapter 8), or to avoid inflation and promote employment (Chapter 9).

So far, in Adam Smith's words, "the uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived," has been "powerful enough to maintain the natural progress of things toward improvement, in spite both of the extravagance of governments and of the greatest errors of administration. Like the unknown principle of animal life, it frequently restores health and vigour to the constitution, in spite, not only of the disease, but of the absurd prescriptions of the doctor." [3] So far, that is, Adam Smith's invisible hand has been powerful enough to overcome the deadening effects of the invisible hand that operates in the political sphere.

The experience of recent years—slowing growth and declining productivity—raises a doubt whether private ingenuity can continue to overcome the deadening effects of government control if we continue to grant ever more power to government, to authorize a "new class" of civil servants to spend ever larger fractions of our income supposedly on our behalf. Sooner or later—and perhaps sooner than many of us expect—an ever bigger government would destroy both the prosperity that we owe to the free market and the human freedom proclaimed so eloquently in the Declaration of Independence.

We have not yet reached the point of no return. We are still free as a people to choose whether we shall continue speeding down the "road to serfdom," as Friedrich Hayek entitled his profound and influential book, or whether we shall set tighter limits on government and rely more heavily on voluntary cooperation among free individuals to achieve our several objectives. Will our golden age come to an end in a relapse into the tyranny and misery that has always been, and remains today, the state of most

of mankind? Or shall we have the wisdom, the foresight, and the courage to change our course, to learn from experience, and to benefit from a "rebirth of freedom"?

If we are to make that choice wisely, we must understand the fundamental principles of our system, both the economic principles of Adam Smith, which explain how it is that a complex, organized, smoothly running system can develop and flourish without central direction, how coordination can be achieved without coercion (Chapter 1); and the political principles expressed by Thomas Jefferson (Chapter 5). We must understand why it is that attempts to replace cooperation by central direction are capable of doing so much harm (Chapter 2). We must understand also the intimate connection between political freedom and economic freedom.

Fortunately, the tide is turning. In the United States, in Great Britain, the countries of Western Europe, and in many other countries around the world, there is growing recognition of the dangers of big government, growing dissatisfaction with the policies that have been followed. This shift is being reflected not only in opinion, but also in the political sphere. It is becoming politically profitable for our representatives to sing a different tune—and perhaps even to act differently. We are experiencing another major change in public opinion. We have the opportunity to nudge the change in opinion toward greater reliance on individual initiative and voluntary cooperation, rather than toward the other extreme of total collectivism.

In our final chapter, we explore why it is that in a supposedly democratic political system special interests prevail over the general interest. We explore what we can do to correct the defect in our system that accounts for that result, how we can limit government while enabling it to perform its essential functions of defending the nation from foreign enemies, protecting each of us from coercion by our fellow citizens, adjudicating our disputes, and enabling us to agree on the rules that we shall follow.

CHAPTER 1

The Power of the Market

Every day each of us uses innumerable goods and services—to eat, to wear, to shelter us from the elements, or simply to enjoy. We take it for granted that they will be available when we want to buy them. We never stop to think how many people have played a part in one way or another in providing those goods and services. We never ask ourselves how it is that the corner grocery store—or nowadays, supermarket—has the items on its shelves that we want to buy, how it is that most of us are able to earn the money to buy those goods.

It is natural to assume that someone must give orders to make sure that the "right" products are produced in the "right" amounts and available at the "right" places. That is one method of coordinating the activities of a large number of people—the method of the army. The general gives orders to the colonel, the colonel to the major, the major to the lieutenant, the lieutenant to the sergeant, and the sergeant to the private.

But that command method can be the exclusive or even principal method of organization only in a very small group. Not even the most autocratic head of a family can control every act of other family members entirely by order. No sizable army can really be run entirely by command. The general cannot conceivably have the information necessary to direct every movement of the lowliest private. At every step in the chain of command, the soldier, whether officer or private, must have discretion to take into account information about specific circumstances that his commanding officer could not have. Commands must be supplemented by voluntary cooperation—a less obvious and more subtle, but far more fundamental, technique of coordinating the activities of large numbers of people.

Russia is the standard example of a large economy that is supposed to be organized by command—a centrally planned economy. But that is more fiction than fact. At every level of the economy, voluntary cooperation enters to supplement central planning or to offset its rigidities—sometimes legally, sometimes illegally.[1]

In agriculture, full-time workers on government farms are permitted to grow food and raise animals on small private plots in their spare time for their own use or to sell in relatively free markets. These plots account for less than 1 percent of the agricultural land in the country, yet they are said to provide nearly a third of total farm output in the Soviet Union (are "said to" because it is likely that some products of government farms are clandestinely marketed as if from private plots).

In the labor market individuals are seldom ordered to work at specific jobs; there is little actual direction of labor in this sense. Rather, wages are offered for various jobs, and individuals apply for them—much as in capitalist countries. Once hired, they may subsequently be fired or may leave for jobs they prefer. Numerous restrictions affect who may work where, and, of course, the laws prohibit anyone from setting up as an employer—although numerous clandestine workshops serve the extensive black market. Allocation of workers on a large scale primarily by compulsion is just not feasible; and neither, apparently, is complete suppression of private entrepreneurial activity.

The attractiveness of different jobs in the Soviet Union often depends on the opportunities they offer for extralegal or illegal moonlighting. A resident of Moscow whose household equipment fails may have to wait months to have it repaired if he calls the state repair office. Instead, he may hire a moonlighter—very likely someone who works for the state repair office. The householder gets his equipment repaired promptly; the moonlighter gets some extra income. Both are happy.

These voluntary market elements flourish despite their inconsistency with official Marxist ideology because the cost of eliminating them would be too high. Private plots could be forbidden—but the famines of the 1930s are a stark reminder of the cost. The Soviet economy is hardly a model of efficiency now. Without the voluntary elements it would operate at an even lower level of effectiveness. Recent experience in Cambodia tragically illustrates the cost of trying to do without the market entirely.

Just as no society operates entirely on the command principle, so none operates entirely through voluntary cooperation. Every society has some command elements. These take many forms. They may be as straightforward as military conscription or forbidding the purchase and sale of heroin or cyclamates or court orders to named defendants to desist from or perform specified actions. Or, at the other extreme, they may be as subtle as imposing a heavy tax on cigarettes to discourage smoking—a hint, if not a command, by some of us to others of us.

It makes a vast difference what the mix is—whether voluntary exchange is primarily a clandestine activity that flourishes because of the rigidities of a dominant command element, or whether voluntary exchange is the dominant principle of organization, supplemented to a smaller or larger extent by command elements. Clandestine voluntary exchange may prevent a command economy from collapsing, may enable it to creak along and even achieve some progress. It can do little to undermine the tyranny on which a predominantly command economy rests. A predominantly voluntary exchange economy, on the other hand, has within it the potential to promote both prosperity and human freedom. It may not achieve its potential in either respect, but we know of no society that has ever achieved prosperity and freedom unless voluntary exchange has been its dominant principle of organization. We hasten to add that voluntary exchange is not a sufficient condition for prosperity and freedom. That, at least, is the lesson of history to date. Many societies organized predominantly by voluntary exchange have not achieved either prosperity or freedom, though they have achieved a far greater measure of both than authoritarian societies. But voluntary exchange is a necessary condition for both prosperity and freedom.

COOPERATION THROUGH VOLUNTARY EXCHANGE

A delightful story called "I, Pencil: My Family Tree as Told to Leonard E. Read"[2] dramatizes vividly how voluntary exchange enables millions of people to cooperate with one another. Mr. Read, in the voice of the "Lead Pencil—the ordinary wooden pencil familiar to all boys and girls and adults who can read and write," starts his story with the fantastic statement that "*not a* *single person . . . knows how to make me.*" Then he proceeds to tell about all the things that go into the making of a pencil. First, the wood comes from a tree, "a cedar of straight grain that grows in Northern California and Oregon." To cut down the tree and cart the logs to the railroad siding requires "saws and trucks and rope and . . . countless other gear." Many persons and numberless skills are involved in their fabrication: in "the mining of ore, the making of steel and its refinement into saws, axes, motors; the growing of hemp and bringing it through all the stages to heavy and strong rope; the logging camps with their beds and mess halls, . . . untold thousands of persons had a hand in every cup of coffee the loggers drink!"

And so Mr. Read goes on to the bringing of the logs to the mill, the millwork involved in converting the logs to slats, and the transportation of the slats from California to Wilkes-Barre, where the particular pencil that tells the story was manufactured. And so far we have only the outside wood of the pencil. The "lead" center is not really lead at all. It starts as graphite mined in Ceylon. After many complicated processes it ends up as the lead in the center of the pencil.

The bit of metal—the ferrule—near the top of the pencil is brass. "Think of all the persons," he says, "who mine zinc and copper and those who have the skills to make shiny sheet brass from these products of nature."

What we call the eraser is known in the trade as "the plug." It is thought to be rubber. But Mr. Read tells us the rubber is only for binding purposes. The erasing is actually done by "Factice," a rubberlike product made by reacting rape seed oil from the Dutch East Indies (now Indonesia) with sulfur chloride.

After all of this, says the pencil, "Does anyone wish to challenge my earlier assertion that no single person on the face of this earth knows how to make me?"

None of the thousands of persons involved in producing the pencil performed his task because he wanted a pencil. Some among them never saw a pencil and would not know what it is for. Each saw his work as a way to get the goods and services he wanted—goods and services we produced in order to get the pencil we wanted. Every time we go to the store and buy a pencil, we are exchanging a little bit of our services for the infinitesimal amount of services that each of the thousands contributed toward producing the pencil.

It is even more astounding that the pencil was ever produced. No one sitting in a central office gave orders to these thousands of people. No military police enforced the orders that were not given. These people live in many lands, speak different languages, practice different religions, may even hate one another—yet none of these differences prevented them from cooperating to produce a pencil. How did it happen? Adam Smith gave us the answer two hundred years ago.

THE ROLE OF PRICES

The key insight of Adam Smith's *Wealth of Nations* is misleadingly simple: if an exchange between two parties is voluntary, it will not take place unless both believe they will benefit from it. Most economic fallacies derive from the neglect of this simple insight, from the tendency to assume that there is a fixed pie, that one party can gain only at the expense of another.

This key insight is obvious for a simple exchange between two individuals. It is far more difficult to understand how it can enable people living all over the world to cooperate to promote their separate interests.

The price system is the mechanism that performs this task without central direction, without requiring people to speak to one another or to like one another. When you buy your pencil or your daily bread, you don't know whether the pencil was made or the wheat was grown by a white man or a black man, by a Chinese or an Indian. As a result, the price system enables people to cooperate peacefully in one phase of their life while each one goes about his own business in respect of everything else.

Adam Smith's flash of genius was his recognition that the prices that emerged from voluntary transactions between buyers and sellers—for short, in a free market—could coordinate the activity of millions of people, each seeking his own interest, in such a way as to make everyone better off. It was a startling idea then, and it remains one today, that economic order can emerge as the unintended consequence of the actions of many people, each seeking his own interest.

The price system works so well, so efficiently, that we are not aware of it most of the time. We never realize how well it functions until it is prevented from functioning, and even then we seldom recognize the source of the trouble.

The long gasoline lines that suddenly emerged in 1974 after the OPEC oil embargo, and again in the spring and summer of 1979 after the revolution in Iran, are a striking recent example. On both occasions there was a sharp disturbance in the supply of crude oil from abroad. But that did not lead to gasoline lines in Germany or Japan, which are wholly dependent on imported oil. It led to long gasoline lines in the United States, even though we produce much of our own oil, for one reason and one reason only: because legislation, administered by a government agency, did not permit the price system to function. Prices in some areas were kept by command below the level that would have equated the amount of gasoline available at the gas stations to the amount consumers wanted to buy at that price. Supplies were allocated to different areas of the country by command, rather than in response to the pressures of demand as reflected in price. The result was surpluses in some areas and shortages plus long gasoline lines in others. The smooth operation of the price system—which for many decades had assured every consumer that he could buy gasoline at any of a large number of service stations at his convenience and with a minimal wait—was replaced by bureaucratic improvisation.

Prices perform three functions in organizing economic activity: first, they transmit information; second, they provide an incentive to adopt those methods of production that are least costly and thereby use available resources for the most highly valued purposes; third, they determine who gets how much of the product—the distribution of income. These three functions are closely interrelated.

Transmission of Information

Suppose that, for whatever reason, there is an increased demand for lead pencils—perhaps because a baby boom increases school

enrollment. Retail stores will find that they are selling more pencils. They will order more pencils from their wholesalers. The wholesalers will order more pencils from the manufacturers. The manufacturers will order more wood, more brass, more graphite—all the varied products used to make a pencil. In order to induce their suppliers to produce more of these items, they will have to offer higher prices for them. The higher prices will induce the suppliers to increase their work force to be able to meet the higher demand. To get more workers they will have to offer higher wages or better working conditions. In this way ripples spread out over ever widening circles, transmitting the information to people all over the world that there is a greater demand for pencils—or, to be more precise, for some product they are engaged in producing, for reasons they may not and need not know.

The price system transmits only the important information and only to the people who need to know. The producers of wood, for example, do not have to know whether the demand for pencils has gone up because of a baby boom or because 14,000 more government forms have to be filled out in pencil. They don't even have to know that the demand for pencils has gone up. They need to know only that someone is willing to pay more for wood and that the higher price is likely to last long enough to make it worthwhile to satisfy the demand. Both items of information are provided by market prices—the first by the current price, the second by the price offered for future delivery.

A major problem in transmitting information efficiently is to make sure that everyone who can use the information gets it without clogging the "in" baskets of those who have no use for it. The price system automatically solves this problem. The people who transmit the information have an incentive to search out the people who can use it and they are in a position to do so. People who can use the information have an incentive to get it and they are in a position to do so. The pencil manufacturer is in touch with people selling the wood he uses. He is always trying to find additional suppliers who can offer him a better product or a lower price. Similarly, the producer of wood is in touch with his customers and is always trying to find new ones. On the other hand, people who are not currently engaged in these activities and are not considering them as future activities have no interest in the price of wood and will ignore it.

The transmission of information through prices is enormously facilitated these days by organized markets and by specialized communication facilities. It is a fascinating exercise to look through the price quotations published daily in, say, the *Wall Street Journal,* not to mention the numerous more specialized trade publications. These prices mirror almost instantly what is happening all over the world. There is a revolution in some remote country that is a major producer of copper, or there is a disruption of copper production for some other reason. The current price of copper will shoot up at once. To find out how long knowledgeable people expect the supplies of copper to be affected, you need merely examine the prices for future delivery on the same page.

Few readers even of the *Wall Street Journal* are interested in more than a few of the prices quoted. They can readily ignore the rest. The *Wall Street Journal* does not provide this information out of altruism or because it recognizes how important it is for the operation of the economy. Rather, it is led to provide this information by the very price system whose functioning it facilitates. It has found that it can achieve a larger or a more profitable circulation by publishing these prices—information transmitted to it by a different set of prices.

Prices not only transmit information from the ultimate buyers to retailers, wholesalers, manufacturers, and owners of resources; they also transmit information the other way. Suppose that a forest fire or strike reduces the availability of wood. The price of wood will go up. That will tell the manufacturer of pencils that it will pay him to use less wood, and it will not pay him to produce as many pencils as before unless he can sell them for a higher price. The smaller production of pencils will enable the retailer to charge a higher price, and the higher price will inform the final user that it will pay him to wear his pencil down to a shorter stub before he discards it, or shift to a mechanical pencil. Again, he doesn't need to know why the pencil has become more expensive, only that it has.

Anything that prevents prices from expressing freely the conditions of demand or supply interferes with the transmission of accurate information. Private monopoly—control over a particular commodity by one producer or a cartel of producers—is one example. That does not prevent the transmission of information through the price system, but it does distort the information transmitted. The quadrupling of the price of oil in 1973 by the oil cartel transmitted very important information. However, the information it transmitted did not reflect a sudden reduction in the supply of crude oil, or a sudden discovery of new technical knowledge about future supplies of oil, or anything else of a physical or technical character bearing on the relative availability of oil and other sources of energy. It simply transmitted the information that a group of countries had succeeded in organizing a price-fixing and market-sharing arrangement.

Price controls on oil and other forms of energy by the U.S. government in their turn prevented information about the effect of the OPEC cartel from being transmitted accurately to users of petroleum. The result both strengthened the OPEC cartel, by preventing a higher price from leading U.S. consumers to economize on the use of oil, and required the introduction of major command elements in the United States in order to allocate the scarce supply (by a Department of Energy spending in 1979 about $10 billion and employing 20,000 people).

Important as private distortions of the price system are, these days the government is the major source of interference with a free market system—through tariffs and other restraints on international trade, domestic action fixing or affecting individual prices, including wages (see Chapter 2), government regulation of specific industries (see Chapter 7), monetary and fiscal policies producing erratic inflation (see Chapter 9), and numerous other channels.

One of the major adverse effects of erratic inflation is the introduction of static, as it were, into the transmission of information through prices. If the price of wood goes up, for example, producers of wood cannot know whether that is because inflation is raising all prices or because wood is now in greater demand or lower supply relative to other products than it was before the price hike. The information that is important for the organization of production is primarily about *relative* prices—the price of one item compared with the price of another. High inflation, and particularly highly variable inflation, drowns that information in meaningless static.

Incentives

The effective transmission of accurate information is wasted unless the relevant people have an incentive to act, and act correctly, on the basis of that information. It does no good for the producer of wood to be told that the demand for wood has gone up unless he has some incentive to react to the higher price of wood by producing more wood. One of the beauties of a free price system is that the prices that bring the information also provide both an incentive to react to the information and the means to do so.

This function of prices is intimately connected with the third function—determining the distribution of income—and cannot be explained without bringing that function into the account. The producer's income—what he gets for his activities—is determined by the difference between the amount he receives from the sale of his output and the amount he spends in order to produce it. He balances the one against the other and produces an output such that producing a little more would add as much to his costs as to his receipts. A higher price shifts this margin.

In general, the more he produces, the higher the cost of producing still more. He must resort to wood in less accessible or otherwise less favorable locations; he must hire less skilled workers or pay higher wages to attract skilled workers from other pursuits. But now the higher price enables him to bear these higher costs and so provides both the incentive to increase output and the means to do so.

Prices also provide an incentive to act on information not only about the demand for output but also about the most efficient way to produce a product. Suppose one kind of wood becomes scarcer and therefore more expensive than another. The pencil manufacturer gets that information through a rise in the price of the first kind of wood. Because his income, too, is determined by the difference between sales receipts and costs, he has an incentive to economize on that kind of wood. To take a different example, whether it is less costly for loggers to use a chain saw or handsaw depends on the price of the chain saw and the handsaw, the amount of labor required with each, and the wages of different kinds of labor. The enterprise doing the logging has an incentive to acquire the relevant technical knowledge and to combine it with the information transmitted by prices in order to minimize costs.

Or take a more fanciful case that illustrates the subtlety of the price system. The rise in the price of oil engineered by the OPEC cartel in 1973 altered slightly the balance in favor of the handsaw by raising the cost of operating a chain saw. If that seems far-fetched, consider the effect on the use of diesel-powered versus gasoline-powered trucks to haul logs out of the forests and to the sawmill.

To carry this example one step further, the higher price of oil, insofar as it was permitted to occur, raised the cost of products that used more oil relative to products that used less. Consumers had an incentive to shift from the one to the other. The most obvious examples are shifts from large cars to small ones and from heating by oil to heating by coal or wood. To go much further afield to more remote effects: insofar as the relative price of wood was raised by the higher cost of producing it or by the greater demand for wood as a substitute source of energy, the resulting higher price of lead pencils gave consumers an incentive to economize on pencils! And so on in infinite variety.

We have discussed the incentive effect so far in terms of producers and consumers. But it also operates with respect to workers and owners of other productive resources. A higher demand for wood will tend to produce a higher wage for loggers. This is a signal that labor of that type is in greater demand than before. The higher wage gives workers an incentive to act on that information. Some workers who were indifferent about being loggers or doing something else may now choose to become loggers. More young people entering the labor market may become loggers. Here, too, interference by government, through minimum wages, for example, or by trade unions, through restricting entry, may distort the information transmitted or may prevent individuals from freely acting on that information (see Chapter 8).

Information about prices—whether it be wages in different activities, the rent of land, or the return to capital from different uses—is not the only information that is relevant in deciding how to use a particular resource. It may not even be the most important information, particularly about how to use one's own labor. That decision depends in addition on one's own interests and capacities—what the great economist Alfred Marshall called the whole of the advantages and disadvantages of an occupation, monetary and nonmonetary. Satisfaction in a job may compensate for low wages. On the other hand, higher wages may compensate for a disagreeable job.

Distribution of Income

The income each person gets through the market is determined, as we have seen, by the difference between his receipts from the sale of goods and services and the costs he incurs in producing those goods and services. The receipts consist predominantly of direct payments for the productive resources we own—payments for labor or the use of land or buildings or other capital. The case of the entrepreneur—like the manufacturer of pencils—is different in form but not in substance. His income, too, depends on how much of each productive resource he owns and on the price that the market sets on the services of those resources, though in his case the major productive resource he owns may be the capacity to organize an enterprise, coordinate the resources it uses, assume risks, and so on. He may also own some of the other productive resources used in the enterprise, in which case part of his income is derived from the market price for their services. Similarly, the existence of the modern corporation does not alter matters. We speak loosely of the "corporation's income" or of "business" having an income. That is figurative language. The corporation is an intermediary between its owners—the stockholders—and the resources other than the stockholders' capital, the services of which it purchases. Only people have incomes and

they derive them through the market from the resources they own, whether these be in the form of corporate stock, or of bonds, or of land, or of their personal capacity.

In countries like the United States the major productive resource is personal productive capacity—what economists call "human capital." Something like three-quarters of all income generated in the United States through market transactions takes the form of the compensation of employees (wages and salaries plus supplements), and about half the rest takes the form of the income of proprietors of farms and nonfarm enterprises, which is a mixture of payment for personal services and for owned capital.

The accumulation of physical capital—of factories, mines, office buildings, shopping centers; highways, railroads, airports, cars, trucks, planes, ships; dams, refineries, power plants; houses, refrigerators, washing machines, and so on and on in endless variety—has played an essential role in economic growth. Without that accumulation the kind of economic growth that we have enjoyed could never have occurred. Without the maintenance of inherited capital the gains made by one generation would be dissipated by the next.

But the accumulation of human capital—in the form of increased knowledge and skills and improved health and longevity—has also played an essential role. And the two have reinforced one another. The physical capital enabled people to be far more productive by providing them with the tools to work with. And the capacity of people to invent new forms of physical capital, to learn how to use and get the most out of physical capital, and to organize the use of both physical and human capital on a larger and larger scale enabled the physical capital to be more productive. Both physical and human capital must be cared for and replaced. That is even more difficult and costly for human than for physical capital—a major reason why the return to human capital has risen so much more rapidly than the return to physical capital.

The amount of each kind of resource each of us owns is partly the result of chance, partly of choice by ourselves or others. Chance determines our genes and through them affects our physical and mental capacities. Chance determines the kind of family and cultural environment into which we are born and as a result our opportunities to develop our physical and mental capacity. Chance determines also other resources we may inherit from our parents or other benefactors. Chance may destroy or enhance the resources we start with. But choice also plays an important role. Our decisions about how to use our resources, whether to work hard or take it easy, to enter one occupation or another, to engage in one venture or another, to save or spend—these may determine whether we dissipate our resources or improve and add to them. Similar decisions by our parents, by other benefactors, by millions of people who may have no direct connection with us will affect our inheritance.

The price that the market sets on the services of our resources is similarly affected by a bewildering mixture of chance and choice. Frank Sinatra's voice was highly valued in twentieth-century United States. Would it have been highly valued in twentieth-century India, if he had happened to be born and to live there? Skill as a hunter and trapper had a high value in eighteenth- and nineteenth-century America, a much lower value in twentieth-century America. Skill as a baseball player brought much higher returns than skill as a basketball player in the 1920s; the reverse is true in the 1970s. These are all matters involving chance and choice—in these examples, mostly the choices made by consumers of services that determine the relative market prices of different items. But the price we receive for the services of our resources through the market also depends on our own choices—where we choose to settle, how we choose to use those resources, to whom we choose to sell their services, and so on.

In every society, however it is organized, there is always dissatisfaction with the distribution of income. All of us find it hard to understand why we should receive less than others who seem no more deserving—or why we should be receiving more than so many others whose needs seem as great and whose deserts seem no less. The farther fields always look greener—so we blame the existing system. In a command system envy and dissatisfaction are directed at the rulers. In a free market system they are directed at the market.

One result has been an attempt to separate this function of the price system—distributing income—from its other functions—transmitting information and providing incentives. Much government activity during recent decades in the United States and other countries that rely predominantly on the market has been directed at altering the distribution of income generated by the market in order to produce a different and more equal distribution of income. There is a strong current of opinion pressing for still further steps in this direction. We discuss this movement at greater length in Chapter 5.

However we might wish it otherwise, it simply is not possible to use prices to transmit information and provide an incentive to act on that information without using prices also to affect, even if not completely determine, the distribution of income. If what a person gets does not depend on the price he receives for the services of his resources, what incentive does he have to seek out information on prices or to act on the basis of that information? If Red Adair's income would be the same whether or not he performs the dangerous task of capping a runaway oil well, why should he undertake the dangerous task? He might do so once, for the excitement. But would he make it his major activity? If your income will be the same whether you work hard or not, why should you work hard? Why should you make the effort to search out the buyer who values most highly what you have to sell if you will not get any benefit from doing so? If there is no reward for accumulating capital, why should anyone postpone to a later date what he could enjoy now? Why save? How would the existing physical capital ever have been built up by the voluntary restraint of individuals? If there is no reward for maintaining capital, why should people not dissipate any capital which they have either accumulated or inherited? If prices are prevented from affecting the distribution of income, they cannot be used for other purposes. The only alternative is command. Some authority would have to decide who should produce what and how much. Some authority would have to decide who should sweep the streets and who manage the factory, who should be the policeman and who the physician.

The intimate connection among the three functions of the price system has manifested itself in a different way in the communist countries. Their whole ideology centers on the alleged exploitation of labor under capitalism and the associated superiority of a society based on Marx's dictum: "to each according to his needs, from each according to his ability." But the inability to run a pure command economy has made it impossible for them to separate income completely from prices.

For physical resources—land, buildings, and the like—they have been able to go farthest by making them the property of the government. But even here the effect is a lack of incentive to maintain and improve the physical capital. When everybody owns something, nobody owns it, and nobody has a direct interest in maintaining or improving its condition. That is why buildings in the Soviet Union—like public housing in the United States—look decrepit within a year or two of their construction, why machines in government factories break down and are continuously in need of repair, why citizens must resort to the black market for maintaining the capital that they have for their personal use.

For human resources the communist governments have not been able to go as far as with physical resources, though they have tried to. Even they have had to permit people to own themselves to some extent and to let them make their own decisions, and have had to let prices affect and guide those decisions and determine the income received. They have, of course, distorted those prices, prevented them from being free market prices, but they have been unable to eliminate market forces.

The obvious inefficiencies that have resulted from the command system have led to much discussion by planners in socialist countries—Russia, Czechoslovakia, Hungary, China—of the possibility of making greater use of the market in organizing production. At a conference of economists from East and West, we once heard a brilliant talk by a Hungarian Marxist economist. He had rediscovered for himself Adam Smith's invisible hand—a remarkable if somewhat redundant intellectual achievement. He tried, however, to improve on it in order to use the price system to transmit information and organize production efficiently but not to distribute income. Needless to say, he failed in theory, as the communist countries have failed in practice.

A BROADER VIEW

Adam Smith's "invisible hand" is generally regarded as referring to purchases or sales of goods or services for money. But economic activity is by no means the only area of human life in which a complex and sophisticated structure arises as an unintended consequence of a large number of individuals cooperating while each pursues his own interests.

Consider, for example, language. It is a complex structure that is continually changing and developing. It has a well-defined order, yet no central body planned it. No one decided what words should be admitted into the language, what the rules of grammar should be, which words should be adjectives, which nouns. The French Academy does try to control changes in the French language, but that was a late development. It was established long after French was already a highly structured language and it mainly serves to put the seal of approval on changes over which it has no control. There have been few similar bodies for other languages.

How did language develop? In much the same way as an economic order develops through the market—out of the voluntary interaction of individuals, in this case seeking to trade ideas or information or gossip rather than goods and services with one another. One or another meaning was attributed to a word, or words were added as the need arose. Grammatical usages developed and were later codified into rules. Two parties who want to communicate with one another both benefit from coming to a common agreement about the words they use. As a wider and wider circle of people find it advantageous to communicate with one another, a common usage spreads and is codified in dictionaries. At no point is there any coercion, any central planner who has power to command, though in more recent times government school systems have played an important role in standardizing usage.

Another example is scientific knowledge. The structure of disciplines—physics, chemistry, meteorology, philosophy, humanities, sociology, economics—was not the product of a deliberate decision by anyone. Like Topsy, it "just growed." It did so because scholars found it convenient. It is not fixed, but changes as different needs develop.

Within any discipline the growth of the subject strictly parallels the economic marketplace. Scholars cooperate with one another because they find it mutually beneficial. They accept from one another's work what they find useful. They exchange their findings—by verbal communication, by circulating unpublished papers, by publishing in journals and books. Cooperation is worldwide, just as in the economic market. The esteem or approval of fellow scholars serves very much the same function that monetary reward does in the economic market. The desire to earn that esteem, to have their work accepted by their peers, leads scholars to direct their activities in scientifically efficient directions. The whole becomes greater than the sum of its parts, as one scholar builds on another's work. His work in turn becomes the basis for further development. Modern physics is as much a product of a free market in ideas as a modern automobile is a product of a free market in goods. Here again, developments have been much influenced, particularly recently, by government involvement, which has affected both the resources available and the kinds of knowledge that have been in demand. Yet government has played a secondary role. Indeed, one of the ironies of the situation is that many scholars who have strongly favored government central planning of economic activity have recognized very clearly the danger to scientific progress that would be imposed by central government planning of science, the danger of having priorities imposed from above rather than emerging spontaneously from the gropings and explorations of individual scientists.

A society's values, its culture, its social conventions—all these develop in the same way, through voluntary exchange, spontaneous cooperation, the evolution of a complex structure through trial and error, acceptance and rejection. No monarch ever decreed that the kind of music that is enjoyed by residents of Calcutta, for example, should differ radically from the kind enjoyed by residents of Vienna. These widely different musical cultures developed without anyone's "planning" them that way,

through a kind of social evolution paralleling biological evolution—though, of course, individual sovereigns or even elected governments may have affected the direction of social evolution by sponsoring one or another musician or type of music, just as wealthy private individuals did.

The structures produced by voluntary exchange, whether they be language or scientific discoveries or musical styles or economic systems, develop a life of their own. They are capable of taking many different forms under different circumstances. Voluntary exchange can produce uniformity in some respects combined with diversity in others. It is a subtle process whose general principles of operation can fairly readily be grasped but whose detailed results can seldom be foreseen.

These examples may suggest not only the wide scope for voluntary exchange but also the broad meaning that must be attached to the concept of "self-interest." Narrow preoccupation with the economic market has led to a narrow interpretation of self-interest as myopic selfishness, as exclusive concern with immediate material rewards. Economics has been berated for allegedly drawing far-reaching conclusions from a wholly unrealistic "economic man" who is little more than a calculating machine, responding only to monetary stimuli. That is a great mistake. Self-interest is not myopic selfishness. It is whatever it is that interests the participants, whatever they value, whatever goals they pursue. The scientist seeking to advance the frontiers of his discipline, the missionary seeking to convert infidels to the true faith, the philanthropist seeking to bring comfort to the needy—all are pursuing their interests, as they see them, as they judge them by their own values.

THE ROLE OF GOVERNMENT

Where does government enter into the picture? To some extent government is a form of voluntary cooperation, a way in which people choose to achieve some of their objectives through governmental entities because they believe that is the most effective means of achieving them.

The clearest example is local government under conditions where people are free to choose where to live. You may decide to live in one community rather than another partly on the basis of the kind of services its government offers. If it engages in activities you object to or are unwilling to pay for, and these more than balance the activities you favor and are willing to pay for, you can vote with your feet by moving elsewhere. There is competition, limited but real, so long as there are available alternatives.

But government is more than that. It is also the agency that is widely regarded as having a monopoly on the legitimate use of force or the threat of force as the means through which some of us can legitimately impose restraints through force upon others of us. The role of government in that more basic sense has changed drastically over time in most societies and has differed widely among societies at any given time. Much of the rest of this book deals with how its role has changed in the United States in recent decades, and what the effects of its activities have been.

In this initial sketch we want to consider a very different question. In a society whose participants desire to achieve the greatest possible freedom to choose as individuals, as families, as members of voluntary groups, as citizens of an organized government, what role should be assigned to government?

It is not easy to improve on the answer that Adam Smith gave to this question two hundred years ago:

> All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society. According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from the violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.[3]

The first two duties are clear and straightforward: the protection of individuals in the society from coercion whether it comes from outside or from their fellow citizens. Unless there is such protection, we are not really free to choose. The armed robber's "Your money or your life" offers me a choice, but no one would describe it as a free choice or the subsequent exchange as voluntary.

Of course, as we shall see repeatedly throughout this book, it is one thing to state the purpose that an institution, particularly a governmental institution, "ought" to serve; it is quite another to describe the purposes the institution actually serves. The intentions of the persons responsible for setting up the institution and of the persons who operate it often differ sharply. Equally important, the results achieved often differ widely from those intended.

Military and police forces are required to prevent coercion from without and within. They do not always succeed and the power they possess is sometimes used for very different purposes. A major problem in achieving and preserving a free society is precisely how to assure that coercive powers granted to government in order to preserve freedom are limited to that function and are kept from becoming a threat to freedom. The founders of our country wrestled with that problem in drawing up the Constitution. We have tended to neglect it.

Adam Smith's second duty goes beyond the narrow police function of protecting people from physical coercion; it includes "an exact administration of justice." No voluntary exchange that is at all complicated or extends over any considerable period of time can be free from ambiguity. There is not enough fine print in the world to specify in advance every contingency that might arise and to describe precisely the obligations of the various parties to the exchange in each case. There must be some way to mediate disputes. Such mediation itself can be voluntary and need not involve government. In the United States today, most disagreements that arise in connection with commercial contracts are settled by resort to private arbitrators chosen by a procedure specified in advance. In response to this demand an extensive private judicial system has grown up. But the court of last resort is provided by the governmental judicial system.

This role of government also includes facilitating voluntary exchanges by adopting general rules—the rules of the economic and social game that the citizens of a free society play. The most obvious example is the meaning to be attached to private property. I own a house. Are you "trespassing" on my private property if you fly your private airplane ten feet over my roof? One thousand feet? Thirty thousand feet? There is nothing "natural" about where my property rights end and yours begin. The major way that society has come to agree on the rules of property is through the growth of common law, though more recently legislation has played an increasing role.

Adam Smith's third duty raises the most troublesome issues. He himself regarded it as having a narrow application. It has since been used to justify an extremely wide range of government activities. In our view it describes a valid duty of a government directed to preserving and strengthening a free society; but it can also be interpreted to justify unlimited extensions of government power.

The valid element arises because of the cost of producing some goods or services through strictly voluntary exchanges. To take one simple example suggested directly by Smith's description of the third duty: city streets and general-access highways could be provided by private voluntary exchange, the costs being paid for by charging tolls. But the costs of collecting the tolls would often be very large compared to the cost of building and maintaining the streets or highways. This is a "public work" that it might not "be for the interest of any individual . . . to erect and maintain . . . though it" might be worthwhile for "a great society."

A more subtle example involves effects on "third parties,"

people who are not parties to the particular exchange—the classic "smoke nuisance" case. Your furnace pours forth sooty smoke that dirties a third party's shirt collar. You have unintentionally imposed costs on a third party. He would be willing to let you dirty his collar for a price—but it is simply not feasible for you to identify all of the people whom you affect or for them to discover who has dirtied their collars and to require you to indemnify them individually or reach individual agreements with them.

The effect of your actions on third parties may be to confer benefits rather than impose costs. You landscape your house beautifully, and all passersby enjoy the sight. They would be willing to pay something for the privilege but it is not feasible to charge them for looking at your lovely flowers.

To lapse into technical jargon, there is a "market failure" because of "external" or "neighborhood" effects for which it is not feasible (i.e., would cost too much) to compensate or charge the people affected; third parties have had involuntary exchanges imposed on them.

Almost everything we do has some third-party effects, however small and however remote. In consequence, Adam Smith's third duty may at first blush appear to justify almost any proposed government measure. But there is a fallacy. Government measures also have third-party effects. "Government failure" no less than "market failure" arises from "external" or "neighborhood" effects. And if such effects are important for a market transaction, they are likely also to be important for government measures intended to correct the "market failure." The primary source of significant third-party effects of private actions is the difficulty of identifying the external costs or benefits. When it is easy to identify who is hurt or who is benefited, and by how much, it is fairly straightforward to replace involuntary by voluntary exchange, or at least to require individual compensation. If your car hits someone else's because of your negligence, you can be made to pay him for damages even though the exchange was involuntary. If it were easy to know whose collars were going to be dirtied, it would be possible for you to compensate the people affected, or alternatively, for them to pay you to pour out less smoke.

If it is difficult for private parties to identify who imposes costs or benefits on whom, it is difficult for government to do so. As a result a government attempt to rectify the situation may very well end up making matters worse rather than better—imposing costs on innocent third parties or conferring benefits on lucky bystanders. To finance its activities it must collect taxes, which themselves affect what the taxpayers do—still another third-party effect. In addition, every accretion of government power for whatever purpose increases the danger that government, instead of serving the great majority of its citizens, will become a means whereby some of its citizens can take advantage of others. Every government measure bears, as it were, a smokestack on its back.

Voluntary arrangements can allow for third-party effects to a much greater extent than may at first appear. To take a trivial example, tipping at restaurants is a social custom that leads you to assure better service for people you may not know or ever meet and, in return, be assured better service by the actions of still another group of anonymous third parties. Nonetheless, third-party effects of private actions do occur that are sufficiently important to justify government action. The lesson to be drawn from the misuse of Smith's third duty is not that government intervention is never justified, but rather that the burden of proof should be on its proponents. We should develop the practice of examining both the benefits and the costs of proposed government interventions and require a very clear balance of benefits over costs before adopting them. This course of action is recommended not only by the difficulty of assessing the hidden costs of government intervention but also by another consideration. Experience shows that once government undertakes an activity, it is seldom terminated. The activity may not live up to expectation but that is more likely to lead to its expansion, to its being granted a larger budget, than to its curtailment or abolition.

A fourth duty of government that Adam Smith did not explicitly mention is the duty to protect members of the community who cannot be regarded as "responsible" individuals. Like Adam Smith's third duty, this one, too, is susceptible of great abuse. Yet it cannot be avoided.

Freedom is a tenable objective only for responsible individuals. We do not believe in freedom for madmen or children. We must somehow draw a line between responsible individuals and others,

yet doing so introduces a fundamental ambiguity into our ultimate objective of freedom. We cannot categorically reject paternalism for those whom we consider as not responsible.

For children we assign responsibility in the first instance to parents. The family, rather than the individual, has always been and remains today the basic building block of our society, though its hold has clearly been weakening—one of the most unfortunate consequences of the growth of government paternalism. Yet the assignment of responsibility for children to their parents is largely a matter of expediency rather than principle. We believe, and with good reason, that parents have more interest in their children than anyone else and can be relied on to protect them and to assure their development into responsible adults. However, we do not believe in the right of the parents to do whatever they will with their children—to beat them, murder them, or sell them into slavery. Children are responsible individuals in embryo. They have ultimate rights of their own and are not simply the playthings of their parents.

Adam Smith's three duties, or our four duties of government, are indeed "of great importance," but they are far less "plain and intelligible to common understandings" than he supposed. Though we cannot decide the desirability or undesirability of any actual or proposed government intervention by mechanical reference to one or another of them, they provide a set of principles that we can use in casting up a balance sheet of pros and cons. Even on the loosest interpretation, they rule out much existing government intervention—all those "systems either of preference or of restraint" that Adam Smith fought against, that were subsequently destroyed, but have since reappeared in the form of today's tariffs, governmentally fixed prices and wages, restrictions on entry into various occupations, and numerous other departures from his "simple system of natural liberty." (Many of these are discussed in later chapters.)

LIMITED GOVERNMENT IN PRACTICE

In today's world big government seems pervasive. We may well ask whether there exist any contemporaneous examples of societies that rely primarily on voluntary exchange through the market to organize their economic activity and in which government is limited to our four duties.

Perhaps the best example is Hong Kong—a speck of land next to mainland China containing less than 400 square miles with a population of roughly 4.5 million people. The density of population is almost unbelievable—14 times as many people per square mile as in Japan, 185 times as many as in the United States. Yet they enjoy one of the highest standards of living in all of Asia—second only to Japan and perhaps Singapore.

Hong Kong has no tariffs or other restraints on international trade (except for a few "voluntary" restraints imposed by the United States and some other major countries). It has no government direction of economic activity, no minimum wage laws, no fixing of prices. The residents are free to buy from whom they want, to sell to whom they want, to invest however they want, to hire whom they want, to work for whom they want.

Government plays an important role that is limited primarily to our four duties interpreted rather narrowly. It enforces law and order, provides a means for formulating the rules of conduct, adjudicates disputes, facilitates transportation and communication, and supervises the issuance of currency. It has provided public housing for arriving refugees from China. Though government spending has grown as the economy has grown, it remains among the lowest in the world as a fraction of the income of the people. As a result, low taxes preserve incentives. Businessmen can reap the benefits of their success but must also bear the costs of their mistakes.

It is somewhat ironic that Hong Kong, a Crown colony of Great Britain, should be the modern exemplar of free markets and limited government. The British officials who govern it have enabled Hong Kong to flourish by following policies radically at variance with the welfare state policies that have been adopted by the mother country.

Though Hong Kong is an excellent current example, it is by no means the most important example of limited government and free market societies in practice. For this we must go back in time to the nineteenth century. One example, Japan in the first thirty years after the Meiji Restoration in 1867, we leave for Chapter 2.

Two other examples are Great Britain and the United States. Adam Smith's *Wealth of Nations* was one of the early blows in the battle to end government restrictions on industry and trade. The final victory in that battle came seventy years later, in 1846, with the repeal of the so-called Corn Laws—laws that imposed tariffs and other restrictions on the importation of wheat and other grains, referred to collectively as "corn." That ushered in three-quarters of a century of complete free trade lasting until the outbreak of World War I and completed a transition that had begun decades earlier to a highly limited government, one that left every resident of Britain, in Adam Smith's words quoted earlier, "perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men."

Economic growth was rapid. The standard of life of the ordinary citizen improved dramatically—making all the more visible the remaining areas of poverty and misery portrayed so movingly by Dickens and other contemporary novelists. Population increased along with the standard of life. Britain grew in power and influence around the world. All this while government spending fell as a fraction of national income—from close to one-quarter of the national income early in the nineteenth century to about one-tenth of national income at the time of Queen Victoria's Jubilee in 1897, when Britain was at the very apex of its power and glory.

The United States is another striking example. There were tariffs, justified by Alexander Hamilton in his famous *Report on Manufactures* in which he attempted—with a decided lack of success—to refute Adam Smith's arguments in favor of free trade. But they were modest, by modern standards, and few other government restrictions impeded free trade at home or abroad. Until after World War I immigration was almost completely free (there were restrictions on immigration from the Orient). As the Statue of Liberty inscription has it:

> *Give me your tired, your poor,*
> *Your huddled masses yearning to breathe free,*
> *The wretched refuse of your teeming shore.*
> *Send these, the homeless, tempest-tossed to me:*
> *I lift my lamp beside the golden door.*

They came by the millions, and by the millions they were absorbed. They prospered because they were left to their own devices.

A myth has grown up about the United States that paints the nineteenth century as the era of the robber baron, of rugged, unrestrained individualism. Heartless monopoly capitalists allegedly exploited the poor, encouraged immigration, and then fleeced the immigrants unmercifully. Wall Street is pictured as conning Main Street, as bleeding the sturdy farmers in the Middle West, who survived despite the widespread distress and misery inflicted on them.

The reality was very different. Immigrants kept coming. The early ones might have been fooled, but it is inconceivable that millions kept coming to the United States decade after decade to be exploited. They came because the hopes of those who had preceded them were largely realized. The streets of New York were not paved with gold, but hard work, thrift, and enterprise brought rewards that were not even imaginable in the Old World. The newcomers spread from east to west. As they spread, cities sprang up, ever more land was brought into cultivation. The country grew more prosperous and more productive, and the immigrants shared in the prosperity.

If farmers were exploited, why did their number increase? The prices of farm products did decline. But that was a sign of success, not of failure, reflecting the development of machinery, the bringing under cultivation of more land, and improvements in communication, all of which led to a rapid growth in farm output. The final proof is that the price of farmland rose steadily—hardly a sign that farming was a depressed industry!

The charge of heartlessness, epitomized in the remark that William H. Vanderbilt, a railroad tycoon, is said to have made to an inquiring reporter, "The public be damned," is belied by the flowering of charitable activity in the United States in the nineteenth century. Privately financed schools and colleges multiplied; foreign missionary activity exploded; nonprofit private hospitals, orphanages, and numerous other institutions sprang up like weeds. Almost every charitable or public service organization, from the Society for the Prevention of Cruelty to Animals to the YMCA and YWCA, from the Indian Rights Association to the Salvation Army, dates from that period. Voluntary cooperation is no less effective in organizing charitable activity than in organizing production for profit.

The charitable activity was matched by a burst of cultural activity—art museums, opera houses, symphonies, museums, public libraries arose in big cities and frontier towns alike.

The size of government spending is one measure of government's role. Major wars aside, government spending from 1800 to 1929 did not exceed about 12 percent of the national income. Two-thirds of that was spent by state and local governments, mostly for schools and roads. As late as 1928, federal government spending amounted to about 3 percent of the national income.

The success of the United States is often attributed to its generous natural resources and wide open spaces. They certainly played a part—but then, if they were crucial, what explains the success of nineteenth-century Great Britain and Japan or twentieth-century Hong Kong?

It is often maintained that while a let-alone, limited government policy was feasible in sparsely settled nineteenth-century America, government must play a far larger, indeed dominant, role in a modern urbanized and industrial society. One hour in Hong Kong will dispose of that view.

Our society is what we make it. We can shape our institutions. Physical and human characteristics limit the alternatives available to us. But none prevents us, if we will, from building a society that relies primarily on voluntary cooperation to organize both economic and other activity, a society that preserves and expands human freedom, that keeps government in its place, keeping it our servant and not letting it become our master.

CHAPTER 2

The Tyranny of Controls

In discussing tariffs and other restrictions on international trade in his *Wealth of Nations*, Adam Smith wrote:

> What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. . . . In every country, it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. Their interest is, in this respect, directly opposite to that of the great body of the people.[1]

These words are as true today as they were then. In domestic as well as foreign trade, it is in the interest of "the great body of the people" to buy from the cheapest source and sell to the dearest. Yet "interested sophistry" has led to a bewildering proliferation of restrictions on what we may buy and sell, from whom we may buy and to whom we may sell and on what terms, whom we may employ and whom we may work for, where we may live, and what we may eat and drink.

Adam Smith pointed to "the interested sophistry of merchants and manufacturers." They may have been the chief culprits in his day. Today they have much company. Indeed, there is hardly one of us who is not engaged in "interested sophistry" in one area or another. In Pogo's immortal words, "We have met the enemy and they is us." We rail against "special interests" except when the "special interest" happens to be our own. Each of us knows that what is good for him is good for the country—so *our* "special interest" is different. The end result is a maze of restraints and restrictions that makes almost all of us worse off than we would

be if they were all eliminated. We lose far more from measures that serve other "special interests" than we gain from measures that serve our "special interest."

The clearest example is in international trade. The gains to some producers from tariffs and other restrictions are more than offset by the loss to other producers and especially to consumers in general. Free trade would not only promote our material welfare, it would also foster peace and harmony among nations and spur domestic competition.

Controls on foreign trade extend to domestic trade. They become intertwined with every aspect of economic activity. Such controls have often been defended, particularly for underdeveloped countries, as essential to provide development and progress. A comparison of the experience of Japan after the Meiji Restoration in 1867 and of India after independence in 1947 tests this view. It suggests, as do other examples, that free trade at home and abroad is the best way that a poor country can promote the well-being of its citizens.

The economic controls that have proliferated in the United States in recent decades have not only restricted our freedom to use our economic resources, they have also affected our freedom of speech, of press, and of religion.

INTERNATIONAL TRADE

It is often said that bad economic policy reflects disagreement among the experts; that if all economists gave the same advice, economic policy would be good. Economists often do disagree, but that has not been true with respect to international trade. Ever since Adam Smith there has been virtual unanimity among economists, whatever their ideological position on other issues, that international free trade is in the best interest of the trading countries and of the world. Yet tariffs have been the rule. The only major exceptions are nearly a century of free trade in Great Britain after the repeal of the Corn Laws in 1846, thirty years of free trade in Japan after the Meiji Restoration, and free trade in Hong Kong today. The United States had tariffs throughout the nineteenth century and they were raised still higher in the twentieth century, especially by the Smoot-Hawley tariff bill of 1930, which some scholars regard as partly responsible for the severity of the subsequent depression. Tariffs have since been reduced by repeated international agreements, but they remain high, probably higher than in the nineteenth century, though the vast changes in the kinds of items entering international trade make a precise comparison impossible.

Today, as always, there is much support for tariffs—euphemistically labeled "protection," a good label for a bad cause. Producers of steel and steelworkers' unions press for restrictions on steel imports from Japan. Producers of TV sets and their workers lobby for "voluntary agreements" to limit imports of TV sets or components from Japan, Taiwan, or Hong Kong. Producers of textiles, shoes, cattle, sugar—they and myriad others complain about "unfair" competition from abroad and demand that government do something to "protect" them. Of course, no group makes its claim on the basis of naked self-interest. Every group speaks of the "general interest," of the need to preserve jobs or to promote national security. The need to strengthen the dollar vis-à-vis the mark or the yen has more recently joined the traditional rationalizations for restrictions on imports.

The Economic Case for Free Trade

One voice that is hardly ever raised is the consumer's. So-called consumer special interest groups have proliferated in recent years. But you will search the news media, or the records of congressional hearings in vain, to find any record of their launching a concentrated attack on tariffs or other restrictions on imports, even though consumers are major victims of such measures. The self-styled consumer advocates have other concerns—as we shall see in Chapter 7.

The individual consumer's voice is drowned out in the cacophony of the "interested sophistry of merchants and manufacturers" and their employees. The result is a serious distortion of the issue. For example, the supporters of tariffs treat it as self-evident that the creation of jobs is a desirable end, in and of itself, regardless of what the persons employed do. That is clearly wrong. If all we

want are jobs, we can create any number—for example, have people dig holes and then fill them up again, or perform other useless tasks. Work is sometimes its own reward. Mostly, however, it is the price we pay to get the things we want. Our real objective is not just jobs but productive jobs—jobs that will mean more goods and services to consume.

Another fallacy seldom contradicted is that exports are good, imports bad. The truth is very different. We cannot eat, wear, or enjoy the goods we send abroad. We eat bananas from Central America, wear Italian shoes, drive German automobiles, and enjoy programs we see on our Japanese TV sets. Our gain from foreign trade is what we import. Exports are the price we pay to get imports. As Adam Smith saw so clearly, the citizens of a nation benefit from getting as large a volume of imports as possible in return for its exports, or equivalently, from exporting as little as possible to pay for its imports.

The misleading terminology we use reflects these erroneous ideas. "Protection" really means exploiting the consumer. A "favorable balance of trade" really means exporting more than we import, sending abroad goods of greater total value than the goods we get from abroad. In your private household, you would surely prefer to pay less for more rather than the other way around, yet that would be termed an "unfavorable balance of payments" in foreign trade.

The argument in favor of tariffs that has the greatest emotional appeal to the public at large is the alleged need to protect the high standard of living of American workers from the "unfair" competition of workers in Japan or Korea or Hong Kong who are willing to work for a much lower wage. What is wrong with this argument? Don't we want to protect the high standard of living of our people?

The fallacy in this argument is the loose use of the terms "high" wage and "low" wage. What do high and low wages mean? American workers are paid in dollars; Japanese workers are paid in yen. How do we compare wages in dollars with wages in yen? How many yen equal a dollar? What determines that exchange rate?

Consider an extreme case. Suppose that, to begin with, 360 yen equal a dollar. At this exchange rate, the actual rate of exchange for many years, suppose that the Japanese can produce and sell everything for fewer dollars than we can in the United States—TV sets, automobiles, steel, and even soybeans, wheat, milk, and ice cream. If we had free international trade, we would try to buy all our goods from Japan. This would seem to be the extreme horror story of the kind depicted by defenders of tariffs—we would be flooded with Japanese goods and could sell them nothing.

Before throwing up your hands in horror, carry the analysis one step further. How would we pay the Japanese? We would offer them dollar bills. What would they do with the dollar bills? We have assumed that at 360 yen to the dollar everything is cheaper in Japan, so there is nothing in the U.S. market that they would want to buy. If the Japanese exporters were willing to burn or bury the dollar bills, that would be wonderful for us. We would get all kinds of goods for green pieces of paper that we can produce in great abundance and very cheaply. We would have the most marvelous export industry conceivable.

Of course, the Japanese would not in fact sell us useful goods in order to get useless pieces of paper to bury or burn. Like us, they want to get something real in return for their work. If all goods were cheaper in Japan than in the United States at 360 yen to the dollar, the exporters would try to get rid of their dollars, would try to sell them for 360 yen to the dollar in order to buy the cheaper Japanese goods. But who would be willing to buy the dollars? What is true for the Japanese exporter is true for everyone in Japan. No one will be willing to give 360 yen in exchange for one dollar if 360 yen will buy more of everything in Japan than one dollar will buy in the United States. The exporters, on discovering that no one will buy their dollars at 360 yen, will offer to take fewer yen for a dollar. The price of the dollar in terms of yen will go down—to 300 yen for a dollar, or 250 yen, or 200 yen. Put the other way around, it will take more and more dollars to buy a given number of Japanese yen. Japanese goods are priced in yen, so their price in dollars will go up. Conversely, U.S. goods are priced in dollars, so the more dollars the Japanese get for a given number of yen, the cheaper U.S. goods become to the Japanese in terms of yen.

The price of the dollar in terms of yen would fall until, on the average, the dollar value of goods that the Japanese buy from the United States roughly equaled the dollar value of goods that the United States buys from Japan. At that price everybody who wanted to buy yen for dollars would find someone who was willing to sell him yen for dollars.

The actual situation is, of course, more complicated than this hypothetical example. Many nations, and not merely the United States and Japan, are engaged in trade, and the trade often takes roundabout directions. The Japanese may spend some of the dollars they earn in Brazil, the Brazilians in turn may spend those dollars in Germany, and the Germans in the United States, and so on in endless complexity. However, the principle is the same. People, in whatever country, want dollars primarily to buy useful items, not to hoard.

Another complication is that dollars and yen are used not only to buy goods and services from other countries but also to invest and make gifts. Throughout the nineteenth century the United States had a balance of payments deficit almost every year—an "unfavorable" balance of trade that was good for everyone. Foreigners wanted to invest capital in the United States. The British, for example, were producing goods and sending them to us in return for pieces of paper—not dollar bills, but bonds promising to pay back a sum of money at a later time plus interest. The British were willing to send us their goods because they regarded those bonds as a good investment. On the average, they were right. They received a higher return on their savings than was available in any other way. We, in turn, benefited by foreign investment that enabled us to develop more rapidly than we could have developed if we had been forced to rely solely on our own savings.

In the twentieth century the situation was reversed. U.S. citizens found that they could get a higher return on their capital by investing abroad than they could at home. As a result the United States sent goods abroad in return for evidence of debt—bonds and the like. After World War II, the U.S. government made gifts abroad in the form of the Marshall Plan and other foreign aid programs. We sent goods and services abroad as an expression of our belief that we were thereby contributing to a more peaceful world. These government gifts supplemented private gifts—from charitable groups, churches supporting missionaries, individuals contributing to the support of relatives abroad, and so on.

None of these complications alters the conclusion suggested by the hypothetical extreme case. In the real world, as well as in that hypothetical world, there can be no balance of payments problem so long as the price of the dollar in terms of the yen or the mark or the franc is determined in a free market by voluntary transactions. It is simply not true that high-wage American workers are, as a group, threatened by "unfair" competition from low-wage foreign workers. Of course, particular workers may be harmed if a new or improved product is developed abroad, or if foreign producers become able to produce such products more cheaply. But that is no different from the effect on a particular group of workers of other American firms' developing new or improved products or discovering how to produce at lower costs. That is simply market competition in practice, the major source of the high standard of life of the American worker. If we want to benefit from a vital, dynamic, innovative economic system, we must accept the need for mobility and adjustment. It may be desirable to ease these adjustments, and we have adopted many arrangements, such as unemployment insurance, to do so, but we should try to achieve that objective without destroying the flexibility of the system—that would be to kill the goose that has been laying the golden eggs. In any event, whatever we do should be evenhanded with respect to foreign and domestic trade.

What determines the items it pays us to import and to export? An American worker is currently more productive than a Japanese worker. It is hard to determine just how much more productive—estimates differ. But suppose he is one and a half times as productive. Then, on average, the American's wages would buy about one and a half times as much as a Japanese worker's wages. It is wasteful to use American workers to do anything at which they are less than one and a half times as efficient as their Japanese counterparts. In the economic jargon coined more than 150 years ago, that is the *principle of comparative advantage*. Even if we were more efficient than the Japanese at producing everything, it would not pay us to produce everything. We should concentrate

on doing those things we do best, those things where our superiority is the greatest.

As a homely illustration, should a lawyer who can type twice as fast as his secretary fire the secretary and do his own typing? If the lawyer is twice as good a typist but five times as good a lawyer as his secretary, both he and the secretary are better off if he practices law and the secretary types letters.

Another source of "unfair competition" is said to be subsidies by foreign governments to their producers that enable them to sell in the United States below cost. Suppose a foreign government gives such subsidies, as no doubt some do. Who is hurt and who benefits? To pay for the subsidies the foreign government must tax its citizens. They are the ones who pay for the subsidies. U.S. consumers benefit. They get cheap TV sets or automobiles or whatever it is that is subsidized. Should we complain about such a program of reverse foreign aid? Was it noble of the United States to send goods and services as gifts to other countries in the form of Marshall Plan aid or, later, foreign aid, but ignoble for foreign countries to send us gifts in the indirect form of goods and services sold to us below cost? The citizens of the foreign government might well complain. They must suffer a lower standard of living for the benefit of American consumers and of some of their fellow citizens who own or work in the industries that are subsidized. No doubt, if such subsidies are introduced suddenly or erratically, that will adversely affect owners and workers in U.S. industries producing the same products. However, that is one of the ordinary risks of doing business. Enterprises never complain about unusual or accidental events that confer windfall gains. The free enterprise system is a *profit* and *loss* system. As already noted, any measures to ease the adjustment to sudden changes should be applied evenhandedly to domestic and foreign trade.

In any event, disturbances are likely to be temporary. Suppose that, for whatever reason, Japan decided to subsidize steel very heavily. If no additional tariffs or quotas were imposed, imports of steel into the United States would go up sharply. That would drive down the price of steel in the United States and force steel producers to cut their output, causing unemployment in the steel industry. On the other hand, products made of steel could be purchased more cheaply. Buyers of such products would have extra money to spend on other things. The demand for other items would go up, as would employment in enterprises producing those items. Of course, it would take time to absorb the now unemployed steelworkers. However, to balance that effect, workers in other industries who had been unemployed would find jobs available. There need be no net loss of employment, and there would be a gain in output because workers no longer needed to produce steel would be available to produce something else.

The same fallacy of looking at only one side of the issue is present when tariffs are urged in order to add to employment. If tariffs are imposed on, say, textiles, that will add to output and employment in the domestic textile industry. However, foreign producers who no longer can sell their textiles in the United States earn fewer dollars. They will have less to spend in the United States. Exports will go down to balance decreased imports. Employment will go up in the textile industry, down in the export industries. And the shift of employment to less productive uses will reduce total output.

The national security argument that a thriving domestic steel industry, for example, is needed for defense has no better basis. National defense needs take only a small fraction of total steel used in the United States. And it is inconceivable that complete free trade in steel would destroy the U.S. steel industry. The advantages of being close to sources of supply and fuel and to the market would guarantee a relatively large domestic steel industry. Indeed, the need to meet foreign competition, rather than being sheltered behind governmental barriers, might very well produce a stronger and more efficient steel industry than we have today.

Suppose the improbable did happen. Suppose it did prove cheaper to buy *all* our steel abroad. There are alternative ways to provide for national security. We could stockpile steel. That is easy, since steel takes relatively little space and is not perishable. We could maintain some steel plants in mothballs, the way we maintain ships, to go into production in case of need. No doubt there are still other alternatives. Before a steel company decides to build a new plant, it investigates alternative ways of doing so, alternative locations, in order to choose the most efficient and economical. Yet in all its pleas for subsidies on national security grounds, the steel industry has never presented cost estimates for alternative ways of providing national security. Until they do, we can be sure the national security argument is a rationalization of industry self-interest, not a valid reason for the subsidies.

No doubt the executives of the steel industry and of the steel labor unions are sincere when they adduce national security arguments. Sincerity is a much overrated virtue. We are all capable of persuading ourselves that what is good for us is good for the country. We should not complain about steel producers making such arguments, but about letting ourselves be taken in by them.

What about the argument that we must defend the dollar, that we must keep it from falling in value in terms of other currencies—the Japanese yen, the German mark, or the Swiss franc? That is a wholly artificial problem. If foreign exchange rates are determined in a free market, they will settle at whatever level will clear the market. The resulting price of the dollar in terms of the yen, say, may temporarily fall below the level justified by the cost in dollars and yen respectively of American and Japanese goods. If so, it will give persons who recognize that situation an incentive to buy dollars and hold them for a while in order to make a profit when the price goes up. By lowering the price in yen of American exports to Japanese, it will stimulate American exports; by raising the price in dollars of Japanese goods, it will discourage imports from Japan. These developments will increase the demand for dollars and so correct the initially low price. The price of the dollar, if determined freely, serves the same function as all other prices. It transmits information and provides an incentive to act on that information because it affects the incomes that participants in the market receive.

Why then all the furor about the "weakness" of the dollar? Why the repeated foreign exchange crises? The proximate reason is because foreign exchange rates have not been determined in a free market. Government central banks have intervened on a grand scale in order to influence the price of their currencies. In the process they have lost vast sums of their citizens' money (for the United States close to $2 billion from 1973 to early 1979). Even more important, they have prevented this important set of prices from performing its proper function. They have not been able to prevent the basic underlying economic forces from ultimately having their effect on exchange rates, but have been able to maintain artificial exchange rates for substantial intervals. The effect has been to prevent gradual adjustment to the underlying forces. Small disturbances have accumulated into large ones, and ultimately there has been a major foreign exchange "crisis."

Why have governments intervened in foreign exchange markets? Because foreign exchange rates reflect internal policies. The U.S. dollar has been weak compared to the Japanese yen, the German mark, and the Swiss franc primarily because inflation has been much higher in the United States than in the other countries. Inflation meant that the dollar was able to buy less and less at home. Should we be surprised that it has also been able to buy less abroad? Or that Japanese or Germans or Swiss should not be willing to exchange as many of their own currency units for a dollar? But governments, like the rest of us, go to great lengths to try to conceal or offset the undesirable consequences of their own policies. A government that inflates is therefore led to try to manipulate the foreign exchange rate. When it fails, it blames internal inflation on the decline in the exchange rate, instead of acknowledging that cause and effect run the other way.

In all the voluminous literature of the past several centuries on free trade and protectionism, only three arguments have ever been advanced in favor of tariffs that even in principle may have some validity.

First is the national security argument already mentioned. Although that argument is more often a rationalization for particular tariffs than a valid reason for them, it cannot be denied that on occasion it might justify the maintenance of otherwise uneconomical productive facilities. To go beyond this statement of possibility and establish in a specific case that a tariff or other trade restriction is justified in order to promote national security, it would be necessary to compare the cost of achieving the specific security objective in alternative ways and establish at least a *prima facie* case that a tariff is the least costly way. Such cost comparisons are seldom made in practice.

The second is the "infant industry" argument advanced, for

example, by Alexander Hamilton in his *Report on Manufactures*. There is, it is said, a potential industry which, if once established and assisted during its growing pains, could compete on equal terms in the world market. A temporary tariff is said to be justified in order to shelter the potential industry in its infancy and enable it to grow to maturity, when it can stand on its own feet. Even if the industry could compete successfully once established, that does not of itself justify an initial tariff. It is worthwhile for consumers to subsidize the industry initially—which is what they in effect do by levying a tariff—only if they will subsequently get back at least that subsidy in some other way, through prices later lower than the world price, or through some other advantages of having the industry. But in that case, is a subsidy needed? Will it then not pay the original entrants into the industry to suffer initial losses in the expectation of being able to recoup them later? After all, most firms experience losses in their early years, when they are getting established. That is true if they enter a new industry or if they enter an existing one. Perhaps there may be some special reason why the original entrants cannot recoup their initial losses even though it be worthwhile for the community at large to make the initial investment. But surely the presumption is the other way.

The infant industry argument is a smoke screen. The so-called infants never grow up. Once imposed, tariffs are seldom eliminated. Moreover, the argument is seldom used on behalf of true unborn infants that might conceivably be born and survive if given temporary protection. They have no spokesmen. It is used to justify tariffs for rather aged infants that can mount political pressure.

The third argument for tariffs that cannot be dismissed out of hand is the "beggar-thy-neighbor" argument. A country that is a major producer of a product, or that can join with a small number of other producers that together control a major share of production, may be able to take advantage of its monopoly position by raising the price of the product (the OPEC cartel is the obvious current example). Instead of raising the price directly, the country can do so indirectly by imposing an export tax on the product—an export tariff. The benefit to itself will be less than the cost to others, but from the national point of view, there can be a gain. Similarly, a country that is the primary purchaser of a product—in economic jargon, has monopsony power—may be able to benefit by driving a hard bargain with the sellers and imposing an unduly low price on them. One way to do so is to impose a tariff on the import of the product. The net return to the seller is the price less the tariff, which is why this can be equivalent to buying at a lower price. In effect, the tariff is paid by the foreigners (we can think of no actual example). In practice this nationalistic approach is highly likely to promote retaliation by other countries. In addition, as for the infant industry argument, the actual political pressures tend to produce tariff structures that do not in fact take advantage of any monopoly or monopsony positions.

A fourth argument, one that was made by Alexander Hamilton and continues to be repeated down to the present, is that free trade would be fine if all other countries practiced free trade but that so long as they do not, the United States cannot afford to. This argument has no validity whatsoever, either in principle or in practice. Other countries that impose restrictions on international trade do hurt us. But they also hurt themselves. Aside from the three cases just considered, if we impose restrictions in turn, we simply add to the harm to ourselves and also harm them as well. Competition in masochism and sadism is hardly a prescription for sensible international economic policy! Far from leading to a reduction in restrictions by other countries, this kind of retaliatory action simply leads to further restrictions.

We are a great nation, the leader of the free world. It ill behooves us to require Hong Kong and Taiwan to impose export quotas on textiles to "protect" our textile industry at the expense of U.S. consumers and of Chinese workers in Hong Kong and Taiwan. We speak glowingly of the virtues of free trade, while we use our political and economic power to induce Japan to restrict exports of steel and TV sets. We should move unilaterally to free trade, not instantaneously, but over a period of, say, five years, at a pace announced in advance.

Few measures that we could take would do more to promote the cause of freedom at home and abroad than complete free

trade. Instead of making grants to foreign governments in the name of economic aid—thereby promoting socialism—while at the same time imposing restrictions on the products they produce —thereby hindering free enterprise—we could assume a consistent and principled stance. We could say to the rest of the world: we believe in freedom and intend to practice it. We cannot force you to be free. But we can offer full cooperation on equal terms to all. Our market is open to you without tariffs or other restrictions. Sell here what you can and wish to. Buy whatever you can and wish to. In that way cooperation among individuals can be worldwide and free.

The Political Case for Free Trade

Interdependence is a pervasive characteristic of the modern world: in the economic sphere proper, between one set of prices and another, between one industry and another, between one country and another; in the broader society, between economic activity and cultural, social, and charitable activities; in the organization of society, between economic arrangements and political arrangements, between economic freedom and political freedom.

In the international sphere as well, economic arrangements are intertwined with political arrangements. International free trade fosters harmonious relations among nations that differ in culture and institutions just as free trade at home fosters harmonious relations among individuals who differ in beliefs, attitudes, and interests.

In a free trade world, as in a free economy in any one country, transactions take place among private entities—individuals, business enterprises, charitable organizations. The terms at which any transaction takes place are agreed on by all the parties to that transaction. The transaction will not take place unless all parties believe they will benefit from it. As a result, the interests of the various parties are harmonized. Cooperation, not conflict, is the rule.

When governments intervene, the situation is very different. Within a country, enterprises seek subsidies from their government, either directly or in the form of tariffs or other restrictions on trade. They will seek to evade economic pressures from competitors that threaten their profitability or their very existence by resorting to political pressure to impose costs on others. Intervention by one government in behalf of local enterprises leads enterprises in other countries to seek the aid of their own government to counteract the measures taken by the foreign government. Private disputes become the occasion for disputes between governments. Every trade negotiation becomes a political matter. High government officials jet around the world to trade conferences. Frictions develop. Many citizens of every country are disappointed at the outcome and end up feeling they got the short end of the stick. Conflict, not cooperation, is the rule.

The century from Waterloo to the First World War offers a striking example of the beneficial effects of free trade on the relations among nations. Britain was the leading nation of the world, and during the whole of that century it had nearly complete free trade. Other nations, particularly Western nations, including the United States, adopted a similar policy, if in somewhat diluted form. People were in the main free to buy and sell goods from and to anyone, wherever he lived, whether in the same or a different country, at whatever terms were mutually agreeable. Perhaps even more surprising to us today, people were free to travel all over Europe and much of the rest of the world without a passport and without repeated customs inspection. They were free to emigrate and in much of the world, particularly the United States, free to enter and become residents and citizens.

As a result, the century from Waterloo to the First World War was one of the most peaceful in human history among Western nations, marred only by some minor wars—the Crimean War and the Franco-Prussian Wars are the most memorable—and, of course, a major civil war within the United States, which itself was a result of the major respect—slavery—in which the United States departed from economic and political freedom.

In the modern world, tariffs and similar restrictions on trade have been one source of friction among nations. But a far more troublesome source has been the far-reaching intervention of the state into the economy in such collectivist states as Hitler's Germany, Mussolini's Italy, and Franco's Spain, and especially the

communist countries, from Russia and its satellites to China. Tariffs and similar restrictions distort the signals transmitted by the price system, but at least they leave individuals free to respond to those distorted signals. The collectivist countries have introduced much farther-reaching command elements.

Completely private transactions are impossible between citizens of a largely market economy and of a collectivist state. One side is necessarily represented by government officials. Political considerations are unavoidable, but friction would be minimized if the governments of market economies permitted their citizens the maximum possible leeway to make their own deals with collectivist governments. Trying to use trade as a political weapon or political measures as a means to increase trade with collectivist countries only makes the inevitable political frictions even worse.

Free International Trade and Internal Competition

The extent of competition at home is closely related to international trade arrangements. A public outcry against "trusts" and "monopolies" in the late nineteenth century led to the establishment of the Interstate Commerce Commission and the adoption of the Sherman Anti-Trust Law, later supplemented by many other legislative actions to promote competition. These measures have had very mixed effects. They have contributed in some ways to increased competition, but in others they have had perverse effects.

But no such measure, even if it lived up to every expectation of its sponsors, could do as much to assure effective competition as the elimination of all barriers to international trade. The existence of only three major automobile producers in the United States—and one of those on the verge of bankruptcy—does raise a threat of monopoly pricing. But let the automobile producers *of the world* compete with General Motors, Ford, and Chrysler for the custom of the American buyer, and the specter of monopoly pricing disappears.

So it is throughout. A monopoly can seldom be established within a country without overt and covert government assistance in the form of a tariff or some other device. It is close to impossible to do so on a world scale. The De Beers diamond monopoly is the only one we know of that appears to have succeeded. We know of no other that has been able to exist for long without the direct assistance of governments—the OPEC cartel and earlier rubber and coffee cartels being perhaps the most prominent examples. And most such government-sponsored cartels have not lasted long. They have broken down under the pressure of international competition—a fate that we believe awaits OPEC as well. In a world of free trade, international cartels would disappear even more quickly. Even in a world of trade restrictions, the United States, by free trade, unilateral if necessary, could come close to eliminating any danger of significant internal monopolies.

CENTRAL ECONOMIC PLANNING

Traveling in underdeveloped countries, we have over and over again been deeply impressed by the striking contrast between the ideas about facts held by the intellectuals of those countries and many intellectuals in the West, and the facts themselves.

Intellectuals everywhere take for granted that free enterprise capitalism and a free market are devices for exploiting the masses, while central economic planning is the wave of the future that will set their countries on the road to rapid economic progress. We shall not soon forget the tongue-lashing one of us received from a prominent, highly successful, and extremely literate Indian entrepreneur—physically the very model of the Marxist caricature of an obese capitalist—in reaction to remarks that he correctly interpreted as criticism of India's detailed central planning. He informed us in no uncertain terms that the government of a country as poor as India simply had to control imports, domestic production, and the allocation of investment—and by implication grant him the special privileges in all these areas that are the source of his own affluence—in order to assure that *social* priorities override the selfish demands of individuals. And he was simply echoing the views of the professors and other intellectuals in India and elsewhere.

The facts themselves are very different. Wherever we find any large element of individual freedom, some measure of progress in the material comforts at the disposal of ordinary citizens, and widespread hope of further progress in the future, there we also find that economic activity is organized mainly through the free market. Wherever the state undertakes to control in detail the economic activities of its citizens, wherever, that is, detailed central economic planning reigns, there ordinary citizens are in political fetters, have a low standard of living, and have little power to control their own destiny. The state may prosper and produce impressive monuments. Privileged classes may enjoy a full measure of material comforts. But the ordinary citizens are instruments to be used for the state's purposes, receiving no more than necessary to keep them docile and reasonably productive.

The most obvious example is the contrast between East and West Germany, originally part of one whole, torn asunder by the vicissitudes of warfare. People of the same blood, the same civilization, the same level of technical skill and knowledge inhabit the two parts. Which has prospered? Which had to erect a wall to pen in its citizens? Which must man it today with armed guards, assisted by fierce dogs, minefields, and similar devices of devilish ingenuity in order to frustrate brave and desperate citizens who are willing to risk their lives to leave their communist paradise for the capitalist hell on the other side of the wall?

On one side of that wall the brightly lit streets and stores are filled with cheerful, bustling people. Some are shopping for goods from all over the globe. Others are going to the numerous movie houses or other places of entertainment. They can buy freely newspapers and magazines expressing every variety of opinion. They speak with one another or with strangers on any subject and express a wide range of opinions without a single backward glance over the shoulder. A walk of a few hundred feet, after an hour spent in line, filling in forms and waiting for passports to be returned, will take you, as it took us, to the other side of that wall. There, the streets appear empty; the city, gray and pallid; the store windows, dull; the buildings, grimy. Wartime destruction has not yet been repaired after more than three decades. The only sign of cheerfulness or activity that we found during our brief visit to East Berlin was at the entertainment center. One hour in East Berlin is enough to understand why the authorities put up the wall.

It seemed a miracle when West Germany—a defeated and devastated country—became one of the strongest economies on the continent of Europe in less than a decade. It was the miracle of a free market. Ludwig Erhard, an economist, was the German Minister of Economics. On Sunday, the twentieth of June, 1948, he simultaneously introduced a new currency, today's Deutsche mark, and abolished almost all controls on wages and prices. He acted on a Sunday, he was fond of saying, because the offices of the French, American, and British occupation authorities were closed that day. Given their favorable attitudes toward controls, he was sure that if he had acted when the offices were open, the occupation authorities would have countermanded his orders. His measures worked like a charm. Within days the shops were full of goods. Within months the German economy was humming away.

Even two communist countries, Russia and Yugoslavia, offer a similar, though less extreme, contrast. Russia is closely controlled from the center. It has not been able to dispense wholly with private property and free markets, but it has tried to limit their scope as much as possible. Yugoslavia started down the same road. However, after Yugoslavia under Tito broke with Stalin's Russia, it changed its course drastically. It is still communist but deliberately promotes decentralization and the use of market forces. Most agricultural land is privately owned, its produce sold on relatively free markets. Small enterprises (those that have fewer than five employees) may be privately owned and operated. They are flourishing, particularly in handicrafts and tourism. Larger enterprises are workers' cooperatives—an inefficient form of organization but one that at least provides some opportunity for individual responsibility and initiative. The inhabitants of Yugoslavia are not free. They have a much lower standard of living than the inhabitants of neighboring Austria or other similar Western countries. Yet Yugoslavia strikes the observant traveler who comes to it from Russia, as we did, as a paradise by comparison.

In the Middle East, Israel, despite an announced socialist philosophy and policy and extensive government intervention into the economy, has a vigorous market sector, primarily as an direct consequence of the importance of foreign trade. Its socialist policies have retarded its economic growth, yet its citizens enjoy both more political freedom and a far higher standard of living than the citizens of Egypt, which has suffered from a much more extensive centralization of political power and which has imposed much more rigid controls on economic activity.

In the Far East, Malaysia, Singapore, Korea, Taiwan, Hong Kong, and Japan—all relying extensively on private markets—are thriving. Their people are full of hope. An economic explosion is under way in these countries. As best such things can be measured, the annual income per person in these countries in the late 1970s ranged from about $700 in Malaysia to about $5,000 in Japan. By contrast, India, Indonesia, and Communist China, all relying heavily on central planning, have experienced economic stagnation and political repression. The annual income per person in those countries was less than $250.

The intellectual apologists for centralized economic planning sang the praises of Mao's China until Mao's successors trumpeted China's backwardness and bemoaned the lack of progress during the past twenty-five years. Part of their design to modernize the country is to let prices and markets play a larger role. These tactics may produce sizable gains from the country's present low economic level—as they did in Yugoslavia. However, the gains will be severely limited so long as political control over economic activity remains tight and private property is narrowly limited. Moreover, letting the genie of private initiative out of the bottle even to this limited extent will give rise to political problems that, sooner or later, are likely to produce a reaction toward greater authoritarianism. The opposite outcome, the collapse of communism and its replacement by a market system, seems far less likely, though as incurable optimists, we do not rule it out completely. Similarly, once the aged Marshal Tito dies, Yugoslavia will experience political instability that may produce a reaction toward greater authoritarianism or, far less likely, a collapse of existing collectivist arrangements.

An especially illuminating example, worth examining in greater detail, is the contrast between the experiences of India and Japan —India during the first thirty years after it achieved independence in 1947, and Japan not today but during the first thirty years after the Meiji Restoration in 1867. Economists and social scientists in general can seldom conduct controlled experiments of the kind that are so important in testing hypotheses in the physical sciences. However, experience has here produced something very close to a controlled experiment that we can use to test the importance of the difference in methods of economic organization.

There is a lapse of eight decades in time. In all other respects the two countries were in very similar circumstances at the outset of the periods we compare. Both were countries with ancient civilizations and a sophisticated culture. Each had a highly structured population. Japan had a feudal structure with daimyos (feudal lords) and serfs. India had a rigid caste system with Brahmans at the top and the untouchables, designated by the British the "scheduled castes," at the bottom.

Both countries experienced a major political change that permitted a drastic alteration in political, economic, and social arrangements. In both countries a group of able, dedicated leaders took power. They were imbued with national pride and determined to convert economic stagnation into rapid growth, to transform their countries into great powers.

Almost all differences favored India rather than Japan. The prior rules of Japan had enforced almost complete isolation from the rest of the world. International trade and contact was limited to one visit from one Dutch ship a year. The few Westerners permitted to stay in the country were confined to a small enclave on an island in the harbor of Osaka. Three or more centuries of enforced isolation had left Japan ignorant of the outside world, far behind the West in science and technology, and with almost no one who could speak or read any foreign language other than Chinese.

India was much more fortunate. It had enjoyed substantial economic growth before World War I. That growth was converted into stagnation between the two world wars by the struggle for independence from Britain, but was not reversed. Improvements in transportation had ended the localized famines that had earlier been a recurrent curse. Many of its leaders had been educated in advanced countries of the West, particularly in Great

Britain. British rule left it with a highly skilled and trained civil service, modern factories, and an excellent railroad system. None of these existed in Japan in 1867. India was technologically backward compared to the West, but the differential was less than that between Japan in 1867 and the advanced countries of that day.

India's physical resources, too, were far superior to Japan's. About the only physical advantage Japan had was the sea, which offered easy transportation and a plentiful supply of fish. For the rest, India is nearly nine times as large as Japan, and a much larger percentage of its area consists of relatively level and accessible land. Japan is mostly mountainous. It has only a narrow fringe of habitable and arable land along the seacoasts.

Finally, Japan was on its own. No foreign capital was invested in Japan; no foreign governments or foreign foundations in capitalist countries formed consortiums to make grants or offer low-interest loans to Japan. It had to depend on itself for capital to finance its economic development. It did have one lucky break. In the early years after the Meiji Restoration, the European silk crops experienced a disastrous failure that enabled Japan to earn more foreign exchange by silk exports than she otherwise could have. Aside from that, there were no important fortuitous or organized sources of capital.

India fared far better. Since it achieved independence in 1947, it has received an enormous volume of resources from the rest of the world, mostly as gifts. The flow continues today.

Despite the similar circumstances of Japan in 1867 and India in 1947, the outcome was vastly different. Japan dismantled its feudal structure and extended social and economic opportunity to all its citizens. The lot of the ordinary man improved rapidly, even though population exploded. Japan became a power to be reckoned with on the international political scene. It did not achieve full individual human and political freedom, but it made great progress in that direction.

India paid lip service to the elimination of caste barriers yet made little progress in practice. Differences in income and wealth between the few and the many grew wider, not narrower. Population exploded, as it did in Japan eight decades earlier, but economic output per capita did not. It remained nearly stationary.

Indeed, the standard of life of the poorest third of the population has probably declined. In the aftermath of British rule, India prided itself on being the largest democracy in the world, but it lapsed for a time into a dictatorship that restricted freedom of speech and press. It is in danger of doing so again.

What explains the difference in results? Many observers point to different social institutions and human characteristics. Religious taboos, the caste system, a fatalistic philosophy—all these are said to imprison the inhabitants of India in a straitjacket of tradition. The Indians are said to be unenterprising and slothful. By contrast, the Japanese are lauded as hardworking, energetic, eager to respond to influences from abroad, and incredibly ingenious at adapting what they learn from outside to their own needs.

This description of the Japanese may be accurate today. It was not in 1867. An early foreign resident in Japan wrote: "Wealthy we do not think it [Japan] will ever become. The advantages conferred by Nature, with exception of the climate, and the love of indolence and pleasure of the people themselves forbid it. The Japanese are a happy race, and being content with little are not likely to achieve much." Wrote another: "In this part of the world, principles, established and recognized in the West, appear to lose whatever virtue and vitality they originally possessed and to tend fatally toward weediness and corruption."

Similarly, the description of the Indians may be accurate today for some Indians in India, even perhaps for most, but it certainly is not accurate for Indians who have migrated elsewhere. In many African countries, in Malaya, Hong Kong, the Fiji Islands, Panama, and, most recently, Great Britain, Indians are successful entrepreneurs, sometimes constituting the mainstay of the entrepreneurial class. They have often been the dynamo initiating and promoting economic progress. Within India itself, enclaves of enterprise, drive, and initiative exist wherever it has been possible to escape the deadening hand of government control.

In any event, economic and social progress do not depend on the attributes or behavior of the masses. In every country a tiny minority sets the pace, determines the course of events. In the countries that have developed most rapidly and successfully, a minority of enterprising and risk-taking individuals have forged ahead, created opportunities for imitators to follow, have enabled the majority to increase their productivity.

The characteristics of the Indians that so many outside observers deplore reflect rather than cause the lack of progress. Sloth and lack of enterprise flourish when hard work and the taking of risks are not rewarded. A fatalistic philosophy is an accommodation to stagnation. India has no shortage of people with the qualities that could spark and fuel the same kind of economic development that Japan experienced after 1867, or even that Germany and Japan did after World War II. Indeed, the real tragedy of India is that it remains a subcontinent teeming with desperately poor people when it could, we believe, be a flourishing, vigorous, increasingly prosperous and free society.

We recently came across a fascinating example of how an economic system can affect the qualities of people. Chinese refugees who streamed into Hong Kong after the communists gained power sparked its remarkable economic development and gained a deserved reputation for initiative, enterprise, thrift, and hard work. The recent liberalization of emigration from Red China has produced a new stream of immigrants—from the same racial stock, with the same fundamental cultural traditions, but raised and formed by thirty years of communist rule. We hear from several firms that hired some of these refugees that they are very different from the earlier Chinese entrants into Hong Kong. The new immigrants show little initiative and want to be told precisely what to do. They are indolent and uncooperative. No doubt a few years in Hong Kong's free market will change all that.

What then accounts for the different experiences of Japan from 1867 to 1897 and of India from 1947 to date? We believe that the explanation is the same as for the difference between West and East Germany, Israel and Egypt, Taiwan and Red China. Japan relied primarily on voluntary cooperation and free markets—on the model of the Britain of its time. India relied on central economic planning—on the model of the Britain of its time.

The Meiji government did intervene in many ways and played a key role in the process of development. It sent many Japanese abroad for technical training. It imported foreign experts. It established pilot plants in many industries and gave numerous subsidies to others. But at no time did it try to control the total amount or direction of investment or the structure of output. The state maintained a large interest only in shipbuilding and iron and steel industries that it thought necessary for military power. It retained these industries because they were not attractive to private enterprise and required heavy government subsidies. These subsidies were a drain on Japanese resources. They impeded rather than stimulated Japanese economic progress. Finally, an international treaty prohibited Japan during the first three decades after the Meiji Restoration from imposing tariffs higher than 5 percent. This restriction proved an unmitigated boon to Japan, though it was resented at the time, and tariffs were raised after the treaty prohibitions expired.

India is following a very different policy. Its leaders regard capitalism as synonymous with imperialism, to be avoided at all costs. They embarked on a series of Russian-type five-year plans that outlined detailed programs of investment. Some areas of production are reserved to government; in others private firms are permitted to operate, but only in conformity with The Plan. Tariffs and quotas control imports, subsidies control exports. Self-sufficiency is the ideal. Needless to say, these measures produce shortages of foreign exchange. These are met by detailed and extensive foreign exchange control—a major source both of inefficiency and of special privilege. Wages and prices are controlled. A government permit is required to build a factory or to make any other investment. Taxes are ubiquitous, highly graduated on paper, evaded in practice. Smuggling, black markets, illegal transactions of all kinds are every bit as ubiquitous as taxes, undermining all respect for law, yet performing a valuable social service by offsetting to some extent the rigidity of central planning and making it possible for urgent needs to be satisfied.

Reliance on the market in Japan released hidden and unsuspected resources of energy and ingenuity. It prevented vested interests from blocking change. It forced development to conform to the harsh test of efficiency. Reliance on government controls in India frustrates initiative or diverts it into wasteful channels.

It protects vested interests from the forces of change. It substitutes bureaucratic approval for market efficiency as the criterion of survival.

The experience in the two countries with homemade and factory-made textiles serves to illustrate the difference in policy. Both Japan in 1867 and India in 1947 had extensive production of textiles in the home. In Japan foreign competition did not have much effect on the home production of silk, perhaps because of Japan's advantage in raw silk reinforced by the failure of the European crop, but it all but wiped out the home spinning of cotton and later the hand-loom weaving of cotton cloth. A Japanese factory textile industry developed. At first, it manufactured only the coarsest and lowest-grade fabrics, but then moved to higher and higher grades and ultimately became a major export industry.

In India hand-loom weaving was subsidized and guaranteed a market, allegedly to ease the transition to factory production. Factory production is growing gradually but has been deliberately held back to protect the hand-loom industry. Protection has meant expansion. The number of hand looms roughly doubled from 1948 to 1978. Today, in thousands of villages throughout India, the sound of hand looms can be heard from early morning to late at night. There is nothing wrong with a hand-loom industry, provided it can compete on even terms with other industries. In Japan a prosperous, though extremely small, hand-loom industry still exists. It weaves luxury silk and other fabrics. In India the hand-loom industry prospers because it is subsidized by the government. Taxes are, in effect, imposed on people who are no better off than the ones who operate the looms in order to pay them a higher income than they could earn in a free market.

Early in the nineteenth century Great Britain faced precisely the same problem that Japan did a few decades later and India did more than a century later. The power loom threatened to destroy a prosperous hand-loom weaving industry. A royal commission was appointed to investigate the industry. It considered explicitly the policy followed by India: subsidizing hand-loom weaving and guaranteeing the industry a market. It rejected that policy out of hand on the ground that it would only make the basic problem, an excess of hand-loom weavers, worse—precisely what happened in India. Britain adopted the same solution as Japan—the temporarily harsh but ultimately beneficent policy of letting market forces work.[2]

The contrasting experiences of India and Japan are interesting because they bring out so clearly not only the different results of the two methods of organization but also the lack of relation between objectives pursued and policies adopted. The objectives of the new Meiji rulers—who were dedicated to strengthening the power and glory of their country and who attached little value to individual freedom—were more in tune with the Indian policies than with those they themselves adopted. The objectives of the new Indian leaders—who were ardently devoted to individual freedom—were more in tune with the Japanese policies than with those they themselves adopted.

CONTROLS AND FREEDOM

Though the United States has not adopted central economic planning, we have gone very far in the past fifty years in expanding the role of government in the economy. That intervention has been costly in economic terms. The limitations imposed on our economic freedom threaten to bring two centuries of economic progress to an end. Intervention has also been costly in political terms. It has greatly limited our human freedom.

The United States remains a predominantly free country—one of the freest major countries in the world. However, in the words of Abraham Lincoln's famous "House Divided" speech, "A house divided against itself cannot stand. . . . I do not expect the house to fall, but I do expect it will cease to be divided. It will become all one thing or all the other." He was talking about human slavery. His prophetic words apply equally to government intervention into the economy. Were it to go much further, our divided house would fall on the collectivist side. Fortunately, evidence grows that the public is recognizing the danger and is determined to stop and reverse the trend toward ever bigger government.

All of us are affected by the status quo. We tend to take for granted the situation as it is, to regard it as the natural state of affairs, especially when it has been shaped by a series of small gradual changes. It is hard to appreciate how great the cumulative effect has been. It takes an effort of the imagination to get outside the existing situation and view it with fresh eyes. The effort is well worth making. The result is likely to come as a surprise, not to say a shock.

Economic Freedom

An essential part of economic freedom is freedom to choose how to use our income: how much to spend on ourselves and on what items; how much to save and in what form; how much to give away and to whom. Currently, more than 40 percent of our income is disposed of on our behalf by government at federal, state, and local levels combined. One of us once suggested a new national holiday, "Personal Independence Day—that day in the year when we stop working to pay the expenses of government . . . and start working to pay for the items we severally and individually choose in light of our own needs and desires."[3] In 1929 that holiday would have come on Abraham Lincoln's birthday, February 12; today it would come about May 30; if present trends were to continue, it would coincide with the other Independence Day, July 4, around 1988.

Of course, we have something to say about how much of our income is spent on our behalf by government. We participate in the political process that has resulted in government's spending an amount equal to more than 40 percent of our income. Majority rule is a necessary and desirable expedient. It is, however, very different from the kind of freedom you have when you shop at a supermarket. When you enter the voting booth once a year, you almost always vote for a package rather than for specific items. If you are in the majority, you will at best get both the items you favored and the ones you opposed but regarded as on balance less important. Generally, you end up with something different from what you thought you voted for. If you are in the minority, you must conform to the majority vote and wait for your turn to come. When you vote daily in the supermarket, you get precisely what you voted for, and so does everyone else. The ballot box produces conformity without unanimity; the marketplace, unanimity without conformity. That is why it is desirable to use the ballot box, so far as possible, only for those decisions where conformity is essential.

As consumers, we are not even free to choose how to spend the part of our income that is left after taxes. We are not free to buy cyclamates or laetrile, and soon, perhaps, saccharin. Our physician is not free to prescribe many drugs for us that he may regard as the most effective for our ailments, even though the drugs may be widely available abroad. We are not free to buy an automobile without seat belts, though, for the time being, we are still free to choose whether or not to buckle up.

Another essential part of economic freedom is freedom to use the resources we possess in accordance with our own values—freedom to enter any occupation, engage in any business enterprise, buy from and sell to anyone else, so long as we do so on a strictly voluntary basis and do not resort to force in order to coerce others.

Today you are not free to offer your services as a lawyer, a physician, a dentist, a plumber, a barber, a mortician, or engage in a host of other occupations, without first getting a permit or license from a government official. You are not free to work overtime at terms mutually agreeable to you and your employer, unless the terms conform to rules and regulations laid down by a government official.

You are not free to set up a bank, go into the taxicab business, or the business of selling electricity or telephone service, or running a railroad, busline, or airline, without first receiving permission from a government official.

You are not free to raise funds on the capital markets unless you fill out the numerous pages of forms the SEC requires and unless you satisfy the SEC that the prospectus you propose to issue presents such a bleak picture of your prospects that no investor in his right mind would invest in your project if he took the prospectus literally. And getting SEC approval may cost upwards of $100,000—which certainly discourages the small firms our government professes to help.

Freedom to own property is another essential part of economic freedom. And we do have widespread property ownership. Well over half of us own the homes we live in. When it comes to machines, factories, and similar means of production, the situation is very different. We refer to ourselves as a free private enterprise society, as a capitalist society. Yet in terms of the ownership of corporate enterprise, we are about 46 percent socialist. Owning 1 percent of a corporation means that you are entitled to receive 1 percent of its profits and must share 1 percent of its losses up to the full value of your stock. The 1979 federal corporate income tax is 46 percent on all income over $100,000 (reduced from 48 percent in prior years). The federal government is entitled to 46 cents out of every dollar of profit, and it shares 46 cents out of every dollar of losses (provided there are some earlier profits to offset those losses). The federal government owns 46 percent of every corporation—though not in a form that entitles it to vote directly on corporate affairs.

It would take a book much longer than this one even to list in full all the restrictions on our economic freedom, let alone describe them in detail. These examples are intended simply to suggest how pervasive such restrictions have become.

Human Freedom

Restrictions on economic freedom inevitably affect freedom in general, even such areas as freedom of speech and press.

Consider the following excerpts from a 1977 letter from Lee Grace, then executive vice-president of an oil and gas association. This is what he wrote with respect to energy legislation:

> As you know, the real issue more so than the price per thousand cubic feet is the continuation of the First Amendment of the Constitution, the guarantee of freedom of speech. With increasing regulation, as big brother looks closer over our shoulder, we grow timid against speaking out for truth and our beliefs against falsehoods and wrong doings. Fear of IRS audits, bureaucratic strangulation or government harassment is a powerful weapon against freedom of speech.
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> In the October 31 [1977] edition of the U.S. News & World Report, the Washington Whispers section noted that, "Oil industry officials claim that they have received this ultimatum from Energy Secretary

James Schlesinger: 'Support the Administration's proposed tax on crude oil—or else face tougher regulation and a possible drive to break up the oil companies.' "

His judgment is amply confirmed by the public behavior of oil officials. Tongue-lashed by Senator Henry Jackson for earning "obscene profits," not a single member of a group of oil industry executives answered back, or even left the room and refused to submit to further personal abuse. Oil company executives, who in private express strong opposition to the present complex structure of federal controls under which they operate or to the major extension of government intervention proposed by President Carter, make bland public statements approving the objectives of the controls.

Few businessmen regard President Carter's so-called voluntary wage and price controls as a desirable or effective way to combat inflation. Yet one businessman after another, one business organization after another, has paid lip service to the program, said nice things about it, and promised to cooperate. Only a few, like Donald Rumsfeld, former congressman, White House official, and Cabinet member, had the courage to denounce it publicly. They were joined by George Meany, the crusty octogenarian former head of the AFL-CIO.

It is entirely appropriate that people should bear a cost—if only of unpopularity and criticism—for speaking freely. However, the cost should be reasonable and not disproportionate. There should not be, in the words of a famous Supreme Court decision, "a chilling effect" on free speech. Yet there is little doubt that currently there is such an effect on business executives.

The "chilling effect" is not restricted to business executives. It affects all of us. We know most intimately the academic community. Many of our colleagues in economics and the natural science departments receive grants from the National Science Foundation; in the humanities, from the National Foundation for the Humanities; all those who teach in state universities get their salaries partly from the state legislatures. We believe that the National Science Foundation, the National Foundation for the Humanities, and tax subsidies to higher education are all undesirable and should be terminated. That is undoubtedly a minority view in the academic community, but the minority is much larger than anyone would gather from public statements to that effect.

The press is highly dependent on government—not only as a major source of news but in numerous other day-to-day operating matters. Consider a striking example from Great Britain. The London *Times*, a great newspaper, was prevented from publishing one day several years ago by one of its unions because of a story that it was planning to publish about the union's attempt to influence the content of the paper. Subsequently, labor disputes closed down the paper entirely. The unions in question are able to exercise this power because they have been granted special immunities by government. A national Union of Journalists in Britain is pushing for a closed shop of journalists and threatening to boycott papers that employ nonmembers of the union. All this in the country that was the source of so many of our liberties.

With respect to religious freedom, Amish farmers in the United States have had their houses and other property seized because they refused, on religious grounds, to pay Social Security taxes—and also to accept Social Security benefits. Church schools have had their students cited as truants in violation of compulsory attendance laws because their teachers did not have the requisite slips of paper certifying to their having satisfied state requirements.

Although these examples only scratch the surface, they illustrate the fundamental proposition that freedom is one whole, that anything that reduces freedom in one part of our lives is likely to affect freedom in the other parts.

Freedom cannot be absolute. We do live in an interdependent society. Some restrictions on our freedom are necessary to avoid other, still worse, restrictions. However, we have gone far beyond that point. The urgent need today is to eliminate restrictions, not add to them.