The Economic Way of Thinking and Milton Friedman[1]
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Introduction

In 2012, Milton Friedman would have turned 100. Fifty years ago, in 1962, he published his classic *Capitalism and Freedom*, which stands with books like F.A. Hayek's *The Road to Serfdom* as one of the twentieth century's most influential defenses of the free economy. As an economist and a father, I spend a lot of time thinking about my kids' futures and the legacy I will leave them. The intellectual legacy of Milton Friedman is a legacy of freedom, prosperity, and dignity. If we listen to the lessons that he and others working in the classical liberal tradition have to teach, then ours (and our children's) is a much brighter future.

I've been asked to discuss "The Economic Way of Thinking and Milton Friedman." We will consider several things. First, we're going to consider the economic way of thinking and F.A. Hayek's discussion of "the use of knowledge in society." Second, we're going to consider what has happened to countries that have adopted free-market policies in what the economist Andrei Shleifer has called "The Age of Milton Friedman." Third, we're going to consider the alternatives to capitalism and the consequences of the use of force in an interventionist society. Finally, I'm going to close with a plea for humility on the part of economists, intellectuals, and policymakers. It will

[1] This essay is based on remarks delivered at a Nassau Institute event on May 10, 2012. It also draws from remarks delivered at Rhodes College, Mercer University, Charleston Southern University, the College of Charleston, and McKendree University. I thank Linda Gibson and Rachel Smith for editing.

be a plea that originates in the work of Adam Smith and that sits at the core of the classical liberal tradition. First, let's consider some of the basic principles of economics.

The Use of Knowledge in Society: The Economic Way of Thinking

There are a few key ideas in economics.[2] First, people *act*: they choose goals. They seek ways to achieve them. Second, every action has a cost. Resources are scarce, which means that if you are using your time, your talent, and your treasure for one thing, you necessarily aren't using it for another. To use just one example, you're reading this. It means you're giving up the opportunity to relax on the beach, take a walk, or do any of a number of other things. You might be watching this on TV right now, which means you aren't watching old episodes of *The Simpsons* or *Family Guy*. Every action has a cost. Markets make some of these costs very explicit.

People respond to changes in the costs and benefits of different courses of action. In other words, people respond to incentives. When we change people's incentives, we change their actions. When we change the rules, we change people's incentives. When people have incentives to produce trade, for example, they have incentives to create wealth. One of the most surprising conclusions economics has to offer is the fact that trade creates wealth. Trade allows us to do more with what we have. As barriers to trade crumble, the things we buy get cheaper. But here's the cool thing: the things we sell (like our labor) earn more. Sellers get more for the sweat of their brow and buyers sweat less for the things they buy because of the wealth-creating properties of trade. In a commercial society characterized by secure private property rights and voluntary

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[2] These are discussed in the first chapter of most introductory economics textbooks. I also discuss them in Carden (2010).

exchange, one person's gain is another person's gain, as well. Markets harness knowledge, and prices transmit it.

When people have incentives to expropriate and redistribute, on the other hand, things aren't so cheery. In a political society characterized by expropriation and redistribution, one person's gain is another person's loss.

Historically, the effects of free-market institutions have been dramatic. The western world has seen an explosion in per capita income unlike anything the world has ever seen largely by adopting the institutions of free-market capitalism, which the economist Deirdre McCloskey (2006: 14) defines as a system of social organization based on "private property and free labor without central planning, regulated by the rule of law and by an ethical consensus." Further, McCloskey argues that the rise of the modern world is explained by a rhetorical change: people came to offer a degree of dignity and esteem to commerce that has been largely absent for most of history, and this explains the explosion of innovation we have enjoyed in the last several centuries. It is an explosion that has largely been limited to the West, but it is spreading to other countries that are starting to accept commercial institutions, economic freedom, and commercial dignity.

Consequences: Economic Growth in the "Age of Milton Friedman"

Don't take my word for it. In 2009, the economist Andrei Shleifer published an essay in the *Journal of Economic Literature* in which he summarized some of the things that happened in the world during what he called "The Age of Milton Friedman," which he dated from 1980 to 2005. This was, in his words, a period during which "the world embraced free market policies" and experienced rising living standards across a number of different categories (Shleifer 2009: 123). Why 1980? Shleifer notes that it was in 1979 that Deng Xiaoping began free-market reforms in China and Margaret Thatcher began a program of reform. Ronald Reagan was elected President of the United States in 1980, and he too "embraced free market policies" (Shleifer 2009: 123). In Shleifer's words, "(a)ll three of these leaders professed inspiration from the work of Milton Friedman" (Shleifer 2009: 123).

What happened during "the age of Milton Friedman?" Worldwide growth in per-capita GDP over the 25-year period from 1980 through 2005 was about two percent per year (Shleifer 2009: 124). There were marked improvements in life expectancy, infant mortality, education, and democratization (Shleifer 2009: 124-125). In a number of empirical studies, measures of economic freedom are shown to predict a variety of social indicators including but not limited to per-capita GDP. In short, the case for free markets is not merely convincing but compelling.

The twentieth century gave us two clear experiments that allow us to explain the relationship between economic freedom and prosperity. The first is East and West Germany. The second is North and South Korea. The differences between the countries are explained by a difference in their institutions. West Germany and South Korea adopted free markets. East Germany and North Korea adopted communism. Divergence was clear as West Germany and South Korea became international economic leaders while East Germany and North Korea became laggards.

Some argue that this is all well and good but that we can undoubtedly do better. In the nineteenth and twentieth centuries, a lot of leading intellectuals were convinced that socialism was the answer; today, a lot of people are convinced that even though socialism doesn't work the government should intervene to do a lot of different things. As Ludwig von Mises, Friedrich Hayek, Milton Friedman, and others have shown, socialism and interventionism don't only fail in practice, they also fail in theory. Let's explore the use of force in society.

The Use of Force in Society: The Consequences of Interventionism

Trade creates wealth, but a lot of policies are enacted to restrict or modify trade for the alleged benefit of the poor; however, we have to remember that people respond to incentives. When we change incentives, we change behavior. This leads us to an important conclusion: actions and policies will have unintended consequences. The takeaway here is that meaning to help people is not the same thing as actually helping people.

In his classic essay "The Use of Knowledge in Society," the economist F.A. Hayek explained how market prices are not merely efficient ways of organizing information or useful sets of incentives (Hayek 1945). Market prices are *necessary* if economic calculation is even going to be possible. Just as Ludwig von Mises had done in his 1920 essay "Economic Calculation in the Socialist Commonwealth" (Mises 1990 [1920]), Hayek engaged in an exercise that some scholars today call "robust political economy."[3] In short, they showed how even under the best of assumptions about the knowledge available to the planners and about the planners' motives, private ownership of the means of production and market exchange are necessary if the information needed for rational economic calculation is even going to exist.

[3] See Pennington (2011) for a detailed discussion.

Here's how.[4] Let's assume, as Mises did, that by some miracle we know exactly what to produce, every conceivable way of producing it, and the complete inventory of resources available for production. Let's also assume, as Mises, Hayek, and Friedman did, that the central planners are not motivated by any desire for personal gain but by a desire to do the most good for the society under their care. Even in this ideal case, rational economic calculation is not possible without private ownership of the means of production. Private property gives rise to exchange, which allows the establishment of prices. Prices then allow people to estimate the costs and benefits of their actions. Profits and losses then tell entrepreneurs whether they are using resources wisely or wastefully. When the means of production are commonly owned, there can be no exchange, no prices, and no profits and losses. There can be no economic calculation and no way to know whether a particular production process is wise or wasteful.

Hayek carried this an extra step by pointing out that the economic problem is not one of solving a system of equations given a bunch of constraints. Rather, it is one of assembling and harnessing the knowledge distributed across today billions of individual minds. Hayek referred to what he called "the particular circumstances of time and place" that cannot be known by central planners. To use just one example, my knowledge of "the particular circumstances of time and place" in the Bahamas is actually pretty limited. It would be the height of presumption and folly for me to visit the Bahamas and think I can develop specific solutions to all Bahamian problems. I want to close with a plea for humility that originates in Adam Smith and carries through Milton Friedman.

A Plea for Humility: Adam Smith, Milton Friedman, and Political Economy

[4] Boettke (2012) expands on these themes and explains the logic of production under private ownership of the means of production.

Let's consider two passages from Adam Smith. The first is from *The Theory of Moral Sentiments*; in it, Smith introduces us to a character he calls "the man of system."

> The man of system, on the contrary, is apt to be very wise in his own conceit; and is often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it. He goes on to establish it completely and in all its parts, without any regard either to the great interests, or to the strong prejudices which may oppose it. He seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might chuse to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder (Smith 1982 [1759] VI.II.42).

The second is from *The Wealth of Nations*:

> The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would

> nowhere be so dangerous as in the hands of a man who has folly and presumption enough to fancy himself fit to exercise it (Smith 1982 [1776] IV.2.10).

According to the philosopher James R. Otteson (2010), Smith identifies what Otteson calls the "great mind fallacy," which is the assumption that somewhere there is some person or group who can organize society coherently and do so intentionally and from the top down. You just had an election in the Bahamas, and we're on the verge of a Presidential election in the United States. In so many cases, it's clear that people think the relevant question concerns getting the right leadership. This is a mistake. It isn't about making sure the right people at the top have power. It's about making sure everyone has freedom.

But what does this freedom mean? Interventionism fails. How, then, does freedom empower people to make the most of their God-given potential? Here is Milton Friedman from *Capitalism and Freedom* on how markets coordinate economic activity:

> So long as effective freedom of exchange is maintained, the central feature of the market organization of economic activity is that it prevents one person from interfering with another in respect of most of his activities. The consumer is protected from coercion by the seller because of the presence of other sellers with whom he can deal. The seller is protected from coercion by the consumer because of other consumers to whom he can sell. The employee is protected from coercion by the employer because of other employers for whom he can work, and so on. And the market does this impersonally and without centralized authority.
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> Indeed, a major source of objection to a free economy is precisely that it does this task so well. It gives people what they want instead of what a particular group

> thinks they ought to want. Underlying most arguments against the free market is a lack of belief in freedom itself (Friedman 2002 [1962]:14-15).

"Underlying most arguments against the free market is a lack of belief in freedom itself." And yet the history of the last several centuries has given us numerous reasons both theoretical and empirical to believe in freedom. I do. I hope you will, too. Our future—and our children's future—depends on it.

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