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AN ECONOMIST'S PROTEST

THE OPTIMUM QUANTITY OF MONEY
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A Personal Statement

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evenings) is not really persuaded. He can be converted by the next person of opposite views with whom he spends an evening. The only person who can truly persuade you is yourself. You must turn the issues over in your mind at leisure, consider the many arguments, let them simmer, and after a long time turn your preferences into convictions.

Milton Friedman
Rose D. Friedman
Ely, Vermont
September 28, 1979

"Experience should teach us to be most on our guard to protect liberty when the government's purposes are beneficial. Men born to freedom are naturally alert to repel invasion of their liberty by evil-minded rulers. The greater dangers to liberty lurk in insidious encroachment by men of zeal, well-meaning but without understanding."

—Justice Louis Brandeis,
Olmstead v. *United States*,
277 U.S. 479 (1928)

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.

Central argum

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.

Hayek

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.