

Why Government Is the Problem

Milton Friedman, Wriston Lecture w/Q & A, 1991

When a preacher gives a sermon, he usually has a text. Generally, the text expresses a thought that he agrees with and is going to expound. I have been trying to find the word for an anti-text, because I have a text for my sermon tonight, but it is a text that I am persuaded is wholly wrong. The text comes from the September-October issue of *Freedom Review*, about as inappropriate a place as possible. It is the statement: "Reagan's fatuous doctrine that government is the problem. That's my text for tonight or my anti-text.

The text leaves me two tasks: one, easy; one, difficult. The first task is to demonstrate that government is the problem; that's the easy task. The hard task is to understand why government is the problem. Why is it that able public-spirited people produce such different results according as they operate in the political or the economic market? Why is it that if a random sample of the people in this room were to replace those in Washington, our policies would very likely not be improved? That is the real puzzle for us.

As to the easy task, let me just first count the ways to plagiarize words from a love song in which government is the problem. Let's list our major social problems and ask where they come from.

Showing that Government is the Problem

One of our major social problems is clearly the deterioration of our educational system. Next to the military, education is the largest socialist industry in the United States. Total government spending on schooling—I call it schooling rather than education because not all schooling is education, and conversely—comes close to total government spending on defense. With the so-called peace dividend, it may already exceed it. The amount spent per pupil in the past thirty years has tripled in real terms after allowing for inflation. Input has tripled and output has been going down. Schools have been deteriorating. That problem is unquestionably produced by government.

Lawlessness and crime

If there is any function of government that all but the most extreme anarchist libertarians will agree is appropriate, it is to protect individuals in the society from being coerced by other individuals, to keep you from being hit over the head by a random or nonrandom stranger. Is there anybody who will say we are performing that function well? Far from it. Why not? In part because there are so many laws to break; and the more laws there are to break, the harder it is to prevent them from being broken, not only because of the lack of law enforcement means, but even more, because a growing fraction of the laws fail to command the allegiance of the people. You can only really enforce laws that most people believe to be good laws, laws that proscribe actions that they would avoid even in the absence of laws. When laws render illegal actions that many or most people regard as moral and proper, they can be effectively enforced only by brute force. The speed laws are an obvious example; alcohol prohibition a more dramatic one.

Currently, I believe a major source of our present lawlessness, in particular of the destruction of the inner cities, is the attempt to prohibit so-called drugs. I say so-called drugs because the most harmful drugs in the United States are legal: cigarettes and alcohol. We once tried to prohibit the consumption of alcohol at tremendous cost. We are now trying to prohibit the use of narcotics at tremendous cost. The particular consequence that I find most indefensible is the havoc wreaked on residents of Colombia, Peru, and other countries because we cannot enforce our own laws. I have yet to hear an acceptable justification of that consequence. Coming back home, whether or not you believe that it is

an appropriate function of government to prevent people from voluntarily ingesting items that you regard as harmful to them—and whether you believe that it is an appropriate function of government because of the harm to them or to third parties—the attempt to do so has been a failure. It has caused vastly more harm to innocent victims, including the public at large, and especially the residents of the inner cities, than any good it has done for those who would choose to use the prohibited narcotics if they were legal. There would become innocent victims (e.g., crack babies) even if drugs were legalized. But they would be far fewer, and much more could be done to reduce their number and help the remainder.

Homelessness

What produced the current wave of homelessness around the country that is a disgrace and a scandal? Much of it was produced by government action. Rent control has contributed, though that has been even more damaging in other ways, and so has the governmental decision to empty mental facilities and turn people out on the streets. So have public housing programs, which have destroyed far more housing units than they have built and have let many public housing units become breeding grounds for crime and viciousness.

Breakdown of Family & Family Values

There has been an extraordinary collapse of family values, a growing number of teenage pregnancies, illegitimate births, and one-parent families. Government alone is not responsible for those major social problems; however, government has contributed to them in major degree. One of the Manhattan Institute's most productive achievements was its sponsorship of Charles Murray's study of these phenomena. His book, *Losing Ground*, provides persuasive evidence that these social problems owe a great deal to mistaken and misdirected governmental policies. Personally, I would add that another misdirected governmental policy, which he does not consider, played a key role in the breakdown of social and cultural values – though by a rather indirect route namely, military conscription. But that is an argument for a different day.

Housing Costs & Shortage

Another social problem is the high cost of housing and the destruction of housing. The North Bronx looks like the pictures recently coming from Yugoslavia of areas that have been shelled. There is no doubt what the cause is: rent control in the city of New York, both directly and via the government taking over many dwelling units because rent control prevented owners from keeping them up. The same results have been experienced wherever rent control has been adopted and enforced, though New York is by all odds the worst case.

There has also been a proliferation all over the country of building regulations-zoning laws, and other governmental actions that have raised the cost of housing drastically. A friend in California has been a building contractor since before World War II. I asked him, "Suppose you were to build identically the same house today that you built in 1945 in one of your large housing projects, and suppose that the price of labor, material, and so on were the same now as it was then. How much more would it cost you now than it did then because you must get government permits and demonstrate that you have satisfied government requirements?" He thought about it quite a while and finally concluded: "At least one-quarter of the total cost."

Skyrocketing Medical Costs

Government has played an increasingly large role in medical care. For decades, total spending on medical care was about 3 to 5 percent of national income. It is now 12 or 13 percent, and the acceleration of spending dates from the introduction of Medicare and Medicaid in 1965. Some of you may have seen an article published in that excellent journal of opinion, the Wall Street Journal, in which I cited figures on hospital cost per patient day, adjusted for inflation. The cost was 26 times as high in 1989 as it had been in 1946; personnel per hospital bed was seven times as high, while the number of hospital beds had been cut in half. Great advances in medical care have certainly occurred, but they did so before 1965 as well as after. Those seven times as many people per hospital bed are clearly not people who are attending to patients; they are mostly people who are filling in forms to satisfy government requirements for payment.

Financial Crises

You are all fully aware of the weakness of our financial system. Is there any doubt that that weakness in the financial system owes much to Washington? The savings and loans crisis was produced by government, in the first instance, by the accelerating inflation of the 1970s, which destroyed the net worth of many, then by poor regulation in the 1980s, by the rise in the amount covered by deposit insurance to \$100,000 and, more recently, by the heavy-handed handling of the crisis. You know the litany; I don't have to spell it out for you.

Transportation Problems

We all complain about highway congestion. That is interesting for a different reason. The private automobile industry is able to produce all the automobiles anybody wants to drive, but the government is apparently not able to produce a comparably adequate highway system, a clear contrast.

A similar contrast exists with respect to airlines and airports. The private aircraft industry has been able to build all the aircraft that the commercial airlines wanted to buy; and the airlines have been able to recruit the necessary pilots, attendants, mechanics, and so on. Where is the bottleneck? In airports, in air control facilities. Why? Because those are run by the government.

Botched Economic Policies

I have not even mentioned the botched economic policies: the reverse Reaganomics that the Bush administration has been practicing and that condemns us to a very slow recovery, if any, and to a very slow 1990s. Nor have I mentioned such things as overregulation of industry, or agricultural policies under which taxpayers pay people to grow crops that are going to be destroyed or stored or given away. I have not mentioned tariffs and quotas; or affirmative action and wage and hour laws. Is there any doubt that government is the problem?

None of this means that government does not have a very real function. Indeed, the tragedy is that because government is doing so many things it ought not to be doing, it performs the functions it ought to be performing very badly. There is a real function for government in defending the nation against foreign enemies, in preventing coercion of some individuals by others within the country, in providing a means of deciding on our rules and adjudicating disputes. Those are real functions government ought to perform. As the books by Mr. Huber and Mr. Olson that were mentioned by Mr. Gilder amply demonstrate,

adjudicating disputes is not a place in which the government is performing its function very well. 2 In fact, I perhaps should have added that to my list.

Environmental Pollution

I wonder if any of the liberal pundits who go around saying that the private market and capitalism, not government, is the problem can name any corresponding set of major problems that afflict our society or that derive from private enterprise.

Their knee-jerk answer is clear: pollution. Private enterprise, they will say, is responsible for polluting the air, for polluting the water, for destroying the earth. I suggest to them that they compare the pollution in countries that have really been run by the government, such as Poland or the Soviet Union or Rumania, with the pollution in this country. The difference is not because our government has been more efficient in avoiding pollution. It is because private enterprise finds that it is not profitable to pollute; it is much more profitable to avoid pollution. There is a real function for government in respect of pollution: to set conditions in which the costs are borne by the parties responsible. However, actual government policy has not been either efficient or effective. An example is the Clean Air Bill recently passed, which will do little to clean the air, but much to clean the pockets of industry.

Explaining 'Why Government is the Problem

Special Interests Lobbying

One common explanation of why government is the problem that I have often stressed is the influence of special interests. Government actions often provide concentrated benefits while imposing widely distributed costs. A dramatic example occurred to me yesterday when I was talking to a taxicab driver. You know taxicab drivers are the source of all anecdotes. I have long been interested in the problem of regulation of taxicabs so I asked him what the market price of a medallion to drive a taxicab in New York is. As you know, there are a limited number of taxicabs and they are required to have a medallion. That price is apparently now somewhere between \$100,000 and \$125,000.

It is clear that if you removed the limitation on the number of taxis, the benefits would greatly overwhelm the losses. Consumers would benefit by having a wider range of alternatives. There would be more cabs so there would be a demand for more drivers. In order to attract more drivers, the earnings of drivers would have to rise. In economic jargon, the supply curve is positively sloped.

Why does the limitation in the number of cabs persist? The answer is obvious: the people who now own those medallions would lose. They know they would lose. They are few and they would make a lot of noise at city hall. The people who would end up driving the additional cabs do not know that they would have new jobs or better jobs. There is not one of you in this room who would find it worth his time and effort to go to city hall to testify, in order to get better cab service. It does not pay you to do so. You are right; it is rational ignorance on your part not to do so.

If a private enterprise is a failure, it is closed down—unless it can get a government subsidy to keep it going; if a government enterprise is a failure, it is expanded.

The phenomenon of concentrated benefits and dispersed costs is a valid explanation for many governmental programs. However, I do not believe it goes far enough to explain the kind of situation in which we now are. For example, it does not explain why, once a government enterprise is established, it should be so much less efficient than a comparable private enterprise. Maybe it is concentrated benefits that lead to the establishment of the government enterprise. However, why on those grounds should the Post Office be less efficient than United Parcel Service?

One common answer is that the incentive of profit is stronger than the incentive of public service. In one sense I believe that is right, but in another sense I believe it is completely wrong. The people who run our private enterprises have the same incentive as the people who are involved in our government enterprises. In all cases the incentive is the same: to promote their own interest. My old friend Armen Alchian, who is a professor at the University of California in Los Angeles, once put this point in a very straightforward way. There is one thing, he said, that you can depend on everybody to do, and that is to put his interest above yours. The people who run our private enterprises are the same kind of people as those who run our public enterprises, just as the Chinese in Hong Kong are no different from the Chinese in Mainland China, yet the results are vastly different; just as the West Germans and the East Germans were not different people, yet the results were vastly different.

The point is that the actions that serve self-interest are very different in the private sphere than they are in the public sphere. The bottom line is different. If a group of people start an enterprise in the private sphere, it may be a success or it may be a failure. Most new enterprises are failures. If the enterprise were an obvious success, it would probably already be in existence. If the enterprise is a failure, that means it loses money. The people who own it have a very clear bottom line. To keep it going, they would have to dig into their own pockets. They are reluctant to do that, so they have a strong incentive either to make the enterprise work or to shut it down.

Suppose the same group of people have the same idea, start the same enterprise in the government sector, and the initial results are the same. It is a failure; it does not work. They have a very different bottom line. Nobody likes to admit that he has made a mistake, and they do not have to. They can argue that the initial failure was only because the enterprise was not on a large enough scale. More important, they have a much different and deeper pocket to draw on. With the best intentions in the world, they can try to persuade the people who hold the purse strings to finance the enterprise on a larger scale, to dig deeper into the pockets of the taxpayers in order to keep it going. That explains what is a very general rule: if a private enterprise is a failure, it is closed down—unless it can get a government subsidy to keep it going; if a government enterprise is a failure, it is expanded. I challenge you to find exceptions.

Many examples illustrate the previous point.

Government undertakes an activity that may be desirable at the time. However, once the activity begins, people in both the government and private sector acquire a vested interest in it. If the initial reason for undertaking the activity disappears, they have a strong incentive to find another justification for its continued existence. A clear example in the international sphere is the **International Monetary Fund**. It was established to administer a system of fixed exchange rates. Whether that is a good system or a bad system is beside the point. In

1971, after President Nixon closed the gold window, the fixed exchange rate system collapsed and was replaced by a system of floating exchange rates. The IMF's function disappeared, yet, instead of being disbanded, it changed its function and expanded. It became a relief agency for backward countries and proceeded to dig deeper into the pockets of its sponsors in order to finance them. At Bretton Woods, two agencies were established: one to administer a fixed exchange rate system and the other, the **World Bank**, to perform the function of promoting development. Now you have two agencies to promote development, both of them, in my opinion, doing far more harm than good.

Let me take a very different example in the United States. At the end of World War II, we had **wage and price control**. Under the inflationary conditions, many employers were finding it difficult to recruit employees. They were trying to find ways to get around the limitations of wage control. They began to offer health care as a fringe benefit to attract workers and succeeded in having it treated as a nontaxable fringe benefit. The excuse disappeared once wage and price controls were eliminated, but the tax exemption of health benefits did not disappear; it continued. Nobody was spending any money on it personally; it was at other taxpayers' expense. It created a medical system in which it came to be taken for granted that employees would get their health benefits through their employers, because that way they could get them in a tax-exempt form. As a result, it has become a major propellant of the drive for socialized medicine. It is why you have a large part of the business community fostering socialized medicine.

Subsidies & Restrictions on Imports

Liberal pundits will tell you that the source of our problems is that the public wants all the goodies that government supposedly provides but is too stingy to pay for them. If only, they say, we could get those greedy, stingy people to provide us with more taxes, we could solve all these problems. They may be partly right, but that is very far from the whole story. It surely does not explain why we have **agricultural subsidies**. Do the people of this country really want to pay farmers to grow goods and throw them away or give them away at low prices abroad? To say the public wants the goodies that government supplies may be true for some things like Medicare and Medicaid, but surely it is not true for agricultural subsidies, or restrictions on the import of Japanese cars, restrictions that raised by perhaps \$2,000 or so the cost of a car to a member of the public, and incidentally, did not prevent the decline of the U.S. auto industry. It is not true for sugar import quotas. If you could have a public vote on whether consumers want to pay twice the world price for sugar, do you think that there would be an overwhelming vote saying yes? So it is not true that the people want the goodies.

What the People Think: How They Have Voted

On the contrary, **when people have had the opportunity to vote on this issue, they overwhelmingly vote the other way**. The public at large thinks that government is too large. They do not want to pay higher taxes and they are right. They do not want to pay higher taxes because they know they are not getting their money's worth. In California, the state in which I now live and which has propositions that can be put on the ballot so you can have direct democracy, the people voted for Proposition 13 which started the tax revolt. They voted for what was called the Gann Limit on total government spending. They voted last year to limit the terms of legislators. Connecticut does not have a graduated income tax today because the people voted for it; they have it because Weicker is governor, not because the people wanted it. Repeated ballot measures designed to increase graduation of the state income tax had earlier been defeated.

However, the liberal pundits are wrong in a more fundamental way.

The problem is not that government is spending too little but that it is spending too much. The problem in schooling is that government is spending too much on schooling for the wrong things. The problem in health care is that government is spending too much on health care for the wrong things.

The Problem is... Bureaucracy!

The end result has been that government has become a self-generating monstrosity. Abraham Lincoln talked about a government of the people, by the people, for the people. What we now have is a government of the people, by the bureaucrats, including the legislators who have become bureaucrats, for the bureaucrats. That is what we have in fact.

Again, let me emphasize, the problem is not that bureaucrats are bad people. The problem is, as the Marxists would say, with the system not the people. The self-interest of people in government tends to lead them to behave in a way that is against the self-interest of the rest of us. You remember Adam Smith's famous law of the invisible hand: people who intend only to seek their own benefit are led by an invisible hand to serve a public interest which was no part of their intention. I have said that there is a reverse invisible hand: people who intend to serve only the public interest are led by an invisible hand to serve private interests which it was no part of their intention to serve.

Testimony at Government Hearings: 63 percent of the witnesses in favor of the spending were from government

I believe our present predicament exists because we have gradually developed governmental institutions in which the people effectively have no voice. A recent study by James Payne brought this home to me very clearly. He examined fourteen different government hearings dealing with spending issues. He found, "One thousand fourteen witnesses appeared in favor of the spending. Only seven could be classified as opponents. In other words, pro-spending witnesses outnumbered anti-spending witnesses 145 to one." However, I do not regard that as the most important of his findings. The most important of his findings was that, "Of the 1060 witnesses who appeared, 47 percent were federal administrators, and another 10 percent were state and local officials. An additional 6 percent were congressmen themselves"—or 63 percent of the witnesses in favor of the spending were from government. They were telling us that they should spend our money, I won't say for their benefit, but for what they believed to be our benefit. Payne added, "Overwhelmingly, Congress's views on spending programs are shaped by government officials themselves."³ What is true of spending proposals is equally true of other governmental measures, of sugar quotas, of the tax exemption of medical care provided by employers, of the agricultural subsidies, and so on down the line.

The problem of concentrated benefits and diffused costs is a real problem. However, I do not believe at the moment that it is the key problem. The key problem is that, because of what has happened to the governmental structure and the growth of government, we are unable to practice what we preach. We preach free enterprise to the newly freed communist countries. We tell them to privatize, privatize, privatize, while we ourselves socialize, socialize, socialize.

What can we do about it? We do not have to punish ourselves. This is a great country. It is the richest country in the world; we have the highest standard of living. It is an extraordinary tribute to the virtues of the free market that with less than 50 percent of the total resources the private sector can produce the level of living it produces. We, the people, must once again rule. It will take a major change in the political structure, I believe, to make that possible.

Term Limits will help de-bureaucratize Congress

The one movement that I see on the horizon that seems to offer promise is the movement toward term limits, to debureaucratize at least Congress. Heretical though it may seem, it would be nice to get back to the spoils system instead of the civil service. That would debureaucratize the administration of laws. We now have people in a secure permanent position whose own well-being depends on having government play a major and ever larger role. What you have to do is to debureaucratize it. I see no possibility of getting back to the spoils system in general. However, term limits on congressmen means the spoils system in Congress, since now, congressional staffs are the only governmental employees who are not subject to civil service rules and tenure.

There is a widespread public movement for term limits. The defeat of the term limit amendment in Washington State was an isolated event which was caused in part by the former Governor of California who lobbied for it and frightened many residents of Washington that California was going to try to take over the state. (I am speaking, of course, of Jerry Brown whom you may vote for for President if you wish. Colorado has passed term limits for both state legislators and members of Congress. California has passed term limits for state employees. If the latter is upheld in the courts, I believe California is a very promising place to pass term limits for members of Congress. Of course, members of Congress will tell you that it is unconstitutional for individual states to limit their terms. Maybe it is, but whether it is should be tested. At any rate, something drastic along these lines is essential to reverse the direction in which we are moving.

The U.S. has a great heritage and a great history. Since the beginning of our republic, every generation has been better schooled than its predecessor and has had a higher standard of living. The coming generation threatens to be the first for which that is not true, and that would be a major tragedy. Thank you very much.

Footnotes to Lecture

1. E. J. Dionne, "Why Americans Hate Politics," *Freedom Review*, September-October 1991, p. 45).
2. Peter W. Huber, Liability: The Legal Revolution and Its Consequences (Basic, 1988), and Galileo's Revenge (Basic, 1991); Walter K. Olson, The Litigation Explosion (Dutton, 1991).
3. Quotations from James L. Payne, "Why Congress Can't Kick the Tax and Spend Habit," Imprimis (Hillsdale College), vol. 20, no. 5 (May 1991).

Question-and-Answer Session

FRIEDMAN: The reason I am still standing here is because Bill Hammett asked me earlier if I would be willing to take questions and I said sure. He asked me if I wanted him to administer them or would I do it. I said I would do it. I believe in self-reliance.

QUESTIONER: Why do you believe that this country is not getting the government it wants when the Democrats control practically all the legislative bodies in the country and we have wet liberal Republicans like your esteemed governor in California? The spenders are elected. Reagan seems to have been an aberration.

FRIEDMAN: It has nothing to do with Democrats or Republicans. They are all in the position that I described; they are all-seeking to promote their own self-interest. Reagan was a real aberration in the sense that he was the first President in my lifetime who was elected not because he was saying what the people wanted to hear, but because the people had come around to wanting to hear what he was saying. He said the same thing in 1980 that he had said in 1964 in supporting Goldwater. He could not have been

elected in 1964 and he was elected in 1980. In that sense he was an aberration but, in the sense of reflecting the real underlying feeling of the population, I do not think he was.

As I say, I believe that the reason that we are not getting the government the people want is because there is no way in which they can make their wants effective. It is the same thing as with the cab business. The people in one district can choose not to re-elect their congressman, but that will not change the composition of the government as a whole. You have to change the system and make it possible for the people's will to be heard. Take California. How do I know that the people are not getting the legislation they want? I know that because they overwhelmingly passed term limits on legislators, and a sharp reduction in permissible expenditures on legislative assistance. When they could vote on the legislature as a whole, they voted very differently than they voted on individual legislators. On your logic, Russia was getting the government its people wanted.

QUESTIONER: Sir, the Republicans could have nominated Jack Kemp rather than George Bush.

FRIEDMAN: The Republicans could have nominated Jack Kemp instead of George Bush. Of course they could have, and they made a mistake in not doing so.

QUESTIONER: How important was World War II and the War Production Board in convincing the public of the power of government to "do good"? Second, and I'll tie them together, how important was inflation in the seventies for the success of Reagan? Therefore, are ideas not that important?

FRIEDMAN: On the first issue, I believe the Great Depression was the overwhelmingly important event that persuaded the public that government could do good. The United States was able for 150 years or more to maintain a system that was predominantly private, in which total government spending -federal, state, and local—until 1930 was never more than about 10 or 12 percent of national income, and federal spending in 1929 was 3 percent of national income. The United States was able to maintain that because the public at large was persuaded that government was the problem and that the private enterprise system was the way to go. I may say they were not persuaded of that by the intellectuals because the intellectuals—at least by the turn of the century—were predominantly socialists.

It is interesting to ask how countries become free. Why was it that the United States did not get involved in these measures much earlier? Accident played a large part. In the 1830s, if you go back to the early history of our country, state after state did get involved. The states owned banks—there was the Bank of Ohio, the Bank of Indiana. The states constructed turnpikes and canals, and were engaged in manufacturing businesses. Then came the Panic of 1837, and a major depression, in which most of these state enterprises went broke, and the public at large became persuaded that the states could not run these things. I believe that is one reason why private enterprise flourished for the next century.

In the 1930s, it went the other way. It is ironic that the Great Depression was produced by government but was blamed on the private enterprise system. The organization to which Larry Lindsay is going to go, the Federal Reserve System, explained in its 1933 annual report how much worse things would have been if the Federal Reserve had not behaved so well, yet the Federal Reserve was the chief culprit in making the depression as deep as it was. So the government produced the depression, the private enterprise system got blamed for it, and there was a tremendous change in attitudes. When you say ideas are not important, that change in attitudes would not have been possible if the groundwork had not been laid by the socialist intellectuals in the 1920s. It is interesting to note that every economic plank of the 1928 Socialist Party platform has by now been either wholly or partly enacted.

So ideas are important, but they take a long time and they are not important in and of themselves. Something else has to come along that provides a fertile ground for those ideas. I mentioned the adoption of floating exchange rates in 1971; it was the same thing. Many economists during the prior twenty years

had been talking about how much more desirable floating exchange rates would be. It never got anywhere until gold started leaving the United States and Nixon closed the gold window because he had nothing else he could do. He had to do it. All of a sudden you had a crisis. What happened then was determined by the ideas that had been explored and developed. The same thing is true of what the Manhattan Institute is doing. The ideas it is exploring and developing will not be adopted because they persuade people. I hope they do persuade people, but they will have an influence because, when the time comes that something has to be done, there will be well developed ideas that can be picked up and put to work.

I do believe that ideas have an influence although I believe that you are also right that the accelerating inflation of the seventies was important in enabling Reagan to be elected. However, the accelerating inflation was even more important in causing our present difficulties in considerable part because of what it did to the tax system through bracket creep. I was saying this noontime that I once attended a breakfast with Senator Long when he was Chairman of the Senate Finance Committee. I remember very well one comment. He said, "You know we never could have adopted by 'legislation the rates of tax we now impose on low and middle incomes. When those rates were adopted, they were on high-income people but inflation made them applicable to low-income people." I believe that was an important effect of inflation on expanding government.

QUESTIONER: Could you comment on the current monetary policy of the Federal Reserve? Specifically, do you think the Fed has gone too far or not far enough?

FRIEDMAN: Gone too far in what direction? Do you mean have they gone too far by having zero growth in M2 for the past six months?

QUESTIONER: Well, yes.

FRIEDMAN: Yes, I believe that they have gone too far in having zero growth in M2 for the past six months. I believe that monetary policy in the United States has been on the whole quite good since Alan Greenspan came in as Chairman except for about the past six or nine months. During most of that period, the Fed announced that M2 was going to be its major monetary target, it set goals for M2, and it has kept M2 most of the time within the range of its announced goals. However, for about the past six months or so M2 has been far below the target range. I believe that the reason that has happened—and now we are verging into technical areas that would bore most of you—is because the Fed mistakenly uses the federal funds rate as its operating instrument and because the Street believes that the function of the Fed is to control interest rates. That is not the function of the Fed. The Fed cannot control interest rates although it affects them. What the Fed does is to determine how much money there is. It has not been doing what it says it intends to do. This is an old story; time and again it has happened. The failure of M2 to show any growth over the past six months has played a role in producing the dragging out of the recession and will slow recovery. In any event, we are going to have a mild recovery. By all statistical standards you had a mild recession and mild recessions tend to be followed by mild recoveries. There is a real problem with monetary policy but I believe that it will not be long-lasting. The Fed is getting very much concerned about the situation and I would be surprised if it did not move vigorously.

QUESTIONER: I think your work was very influential in convincing a lot of people that the roots of the inflation of the seventies were fighting the Vietnam War and making the Great Society and doing it by creating money. In the 1980s, it looks as if we financed the Cold War and continued the Great Society but, instead of monetary financing, we did it with debt. How serious do you think the debt overhang is?

FRIEDMAN: I do not believe the debt overhang is the real problem. I believe the real problem is government spending. Government debt is a problem in the long run. Obviously, if the government continues to run deficits for a long period of time, it will sooner or later have to monetize those. So I do not

deny that is a real problem. However, it is a mistake to concentrate on the debt as such instead of why the debt was created, which is by excessive government spending. What is called a deficit is a form of taxation. It is a very bad form of taxation but it is a form of taxation. However, it does have some good features. The deficit is the only thing that is keeping spending from going up still faster. Moreover, I do not know of any component of government expenditures that does less harm than the payment of interest. If interest rates were tomorrow zero so that government did not have to pay any interest, what would happen to the money it saved? Do you think it would reduce the deficit? You are kidding yourself.

QUESTIONER: I would like to strike a little partisan note to something you said earlier about the article by James Payne, but I do remember that he said that the Democratic votes in the Congress were about six times as strong for spending as the Republican votes and he said both parties were the same [unintelligible words here].

FRIEDMAN: I understand; it is not a question but a comment on my partisan neutrality. The statement is that James Payne, in the book I quoted, pointed out that the Democratic vote for more spending was six times the Republican vote. That undoubtedly is true. Mr. Reagan after all came into office to restrain government spending and was highly successful. Except for military spending, all increases in spending during his administration were as a result of earlier laws, mostly the entitlement laws. Total spending as a percentage of national income peaked at 30.5 in 1985 and then fell to 28.1 in 1988, the final year of his administration. Today's problems derive not from the Reagan administration, which was a Republican administration, but from the Bush administration, which is also a Republican administration. Mr. Bush, as I have mentioned, is practicing reverse Reaganomics. He has been raising taxes, encouraging an expansion of spending, which has been rising rapidly, and reregulating on a large scale. Every time you increase tax rates, the deficit goes up. Of course, on the whole, the Republicans have been in favor of private markets and opposed to government markets. However, talk is one thing and action is often very different. I am not really nonpartisan. As I said in a talk to The Young Republicans at Stanford, I am a libertarian with a small "l" and a Republican with a capital "R."

QUESTIONER: Can you tell us—I don't happen to know—under what circumstances you first said the very famous words "There's no such thing as a free lunch"?

FRIEDMAN: Peggy Noonan, who has written some very good words that you have all heard such as "Read my lips"—it's too bad she wasn't able to enforce the words she wrote—asks if I can remember when I first used the words "There's no such thing as a free lunch." The answer is no, I don't remember. However, I am not really the originator of that statement. A colleague of mine at the Hoover Institution tried to trace it back and it originated some time in the nineteenth century out of the phenomenon of saloons. If you bought a beer, they would give you a free lunch. That's where the phrase originally came from. It was made most popular in the form "There ain't no such thing as a free lunch" by Robert Heinlein, who is a science fiction writer and who wrote a wonderful novel called The Moon Is a Harsh Mistress. The novel's setting is a settlement on the moon in which there was a revolt and their motto was "TANSTAAFL"—"There ain't no such thing as a free lunch." I may say that the revolution was a success because of a wonderful near-human computer.

QUESTIONER: I hope you will not think this question a digression; I would submit that it is central to the debate. If there is one thing that distinguishes our society as an economy from all others, it is the diversity of our population. I would like to know specifically what steps you would recommend to turn the diversity of our population into a competitive advantage in the global economy.

FRIEDMAN: I do not believe in the concept of a competitive advantage in the global economy. We are not harmed by other people improving their standard of living relative to ours; we are helped. The notion of competitiveness, of which so much is spoken, makes sense for an individual enterprise but it does not make any sense for a country. Poor countries can trade with rich countries. A country that is inefficient in

almost everything can still trade with one that is very efficient. The economists have a name for that: what determines things is comparative advantage, not absolute advantage. Almost all talk about national competitiveness rests on the, fallacy of not considering what determines the exchange rate. It assumes a given exchange rate and then all sorts of things follow which in practice do not occur because, if the exchange rate is inappropriate, it cannot be maintained.

Let me return to your basic and more important question: how can we take advantage of the diversity of our population in order to maintain the well-being of all of us? The answer is straightforward: by reducing the role of government. One of the books that the Manhattan Institute has just brought out is Linda Chavez's very good book, **Out of the Barrio**, which gives another example of how government creates problems, in this case, through bilingualism. She discusses that very effectively and I recommend her book to all of you. Bilingualism is another example of the people involved not wanting what is imposed on them. How did the Americans absorb the immigrants in the nineteenth century? How did they absorb my mother and father who came to this country at the age of 14 and 16, respectively, with nothing but their hands? I assure you that there was no welfare office they could go to when they came. There was no governmental relief, but they were able to make their way because there were no barriers to their doing so. I talked about taxicabs in this city. One of the most important programs you could have for the disadvantaged in this city would be to eliminate the limitations on cab licenses. Look at the city of Washington where for a long time there were essentially no limits; the cabdrivers are far more heterogeneous in Washington, D.C. than they are in New York.

The great virtue of a free market system is that it does not care what color people are; it does not care what their religion is; it only cares whether they can produce something you want to buy. It is the most effective system we have discovered for people who hate one another to deal with one another.

Thank you.

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