Free to Choose

A Personal Statement

Milton and Rose Friedman

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To Ricky and Patri

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FOREWORD TO THE HARVEST EDITION

When *Free to Choose* was first published a decade ago, we were sufficiently optimistic to label our final chapter "The Tide Is Turning." The climate of opinion was, we thought, shifting away from belief in collectivism and toward a belief in individualism and private markets. We did not dream tha the tide would turn as dramatically as it has—on both sides of the Iron Curtain.

Ten years ago, many people around the world believed that socialism was a viable, even the mos promising, system for promoting material prosperity and human freedom. Few people anywhere in th world believe that today. Idealistic faith in socialism still lives on, but only in some ivory tower enclaves in the West and in some of the most backward countries elsewhere. Ten years ago, many people were convinced that capitalism, based on free private markets, was a deeply flawed system th was not capable of achieving both widely shared prosperity and human freedom. Today conventional wisdom regards capitalism as the only system that can do so.

Is *Free to Choose* outdated and no longer needed now that its main thesis has become conventional wisdom? Far from it. Conventional wisdom may have changed, but conventional practi has not. Political leaders in capitalist countries who cheer the collapse of socialism in other countries continue to favor socialist solutions in their own. They know the words, but they have not learned the tune.

Despite the drastic change in intellectual and popular opinion in the past decade, governments o so-called capitalist countries are just as backward as governments of communist countries in dismantling the socialist practices that have mushroomed in recent decades. The fraction of our income that goes to finance government spending—supposedly on our behalf—has not declined appreciably and in many countries has continued to increase. In the United States, it was 40 percent i 1980 and 42 percent in 1988, down from a high of 44 percent in 1986. Neither has there been much letup in the flood of detailed regulations that control our lives: in 1980, 87,012 pages were added to the *Federal Register*, which records all regulations; in 1988, 53,376 pages. In the words of the Declaration of Independence, our governments continue to erect "a multitude of new offices" and sen "swarms of officers to harass our people and eat out our substance."

Restraints on international trade, analyzed in Chapter 2 of *Free to Choose*, have grown, not declined; some restrictions on prices and wages, particularly exchange controls, have been eliminate or reduced, but others have been added. Our cradle^to-grave Social Security system has become more extensive and is in greater need of reform than ever (Chapter 4); that is equally true of our school system (Chapter 6). The institutions set up to "protect the consumer" and "the worker" continue to have effects opposite to those intended by their well-meaning sponsors (Chapters 7 and 8). In these and other areas, the momentum of past practices has overwhelmed the effect of a changed climate of opinion.

There has been a substantial improvement in the rate of inflation, which has declined worldwide —in the U.S., from well over 10 percent a year to less than 5 percent. However, inflation is by no means conquered, and our analysis of the causes, consequences, and cure of inflation in Chapter 9 remains valid and highly relevant to assure that recent reductions in inflation are more than a flash in the pan.

The big change has been not in achievements but in prospects. Free private markets are far more likely to multiply in coming years than seemed possible ten years ago. As a result, a book that explains how free private markets work, what their advantages are, and how to eliminate obstacles to their more effective operation has even greater relevance today than it had ten years ago.

Some specific figures and references in our book are now out of date, but we have thought it bes to reprint the manuscript essentially unchanged. A thorough revision of the book to bring it up to dat and to include the new problems that have arisen in the interim might well be worthwhile, but we hav not been in a position to undertake the task and concluded that it was better to leave the manuscript alone than to do a superficial update. We hope that the occasional anachronism will not interfere wit the reader's understanding.

What appeared to many readers of the book ten years ago as Utopian and unrealistic will, we believe, appear to many new readers as almost a blueprint for practical change. We are therefore delighted that Harcourt Brace Jovanovich is issuing a new edition of *Free to Choose*. The tide has turned, but it is still far from the flood tide that is so badly needed to assure a bright future for huma freedom.

Milton and Rose Friedma
January 4, 199

PREFACE

This book has two parents: *Capitalism and Freedom*, our earlier book, published in 1962 (University of Chicago Press); and a TV series, titled, like the book, "Free to Choose." The series will be shown o the Public Broadcasting Service for ten successive weeks in 1980.

Capitalism and Freedom examines "the role of competitive capitalism—the organization of the bulk of economic activity through private enterprise operating in a free market—as a system of economic freedom and a necessary condition for political freedom." In the process, it defines the rol that government should play in a free society.

"Our principles offer," *Capitalism and Freedom* says, "no hard and fast line how far it is appropriate to use government to accomplish jointly what it is difficult or impossible for us to accomplish separately through strictly voluntary exchange. In any particular case of proposed intervention, we must make up a balance sheet, listing separately the advantages and disadvantages. Our principles tell us what items to put on the one side and what items on the other and they give us some basis for attaching importance to the different items."

To give substance to those principles and illustrate their application, *Capitalism and Freedom* examines specific issues—among others, monetary and fiscal policy, the role of government in education, capitalism and discrimination, and the alleviation of poverty.

Free to Choose is a less abstract and more concrete book. Readers of *Capitalism and Freedom* will find here a fuller development of the philosophy that permeates both books—here, there are mor nuts and bolts, less theoretical framework. Moreover, this book is influenced by a fresh approach to political science that has come mainly from economists—Anthony Downs, James M. Buchanan, Gordon Tullock, George J. Stigler, and Gary'S. Becker, who, along with many others, have been doin exciting work in the economic analysis of politics. *Free to Choose* treats the political system symmetrically with the economic system. Both are regarded as markets in which the outcome is determined by the interaction among persons pursuing their own self-interests (broadly interpreted) rather than by the social goals the participants find it advantageous to enunciate. That is implicit throughout the book and explicit in the final chapter.

The TV series covers the same topics as this book: the ten chapters of the book correspond to th ten programs of the TV series and (except for the final chapter) bear the same titles. However, the TV series and the book are very different—each true to its own character. The book covers many items that the time constraints of the TV programs made it necessary to omit or allude to only briefly. And its coverage is more systematic and thorough.

We were induced to undertake the TV series in early 1977 by Robert Chitester, president of PBS station WQLN of Erie, Pennsylvania. His imagination and hard work, and his commitment to the values of a free society, made the series possible. At his suggestion, Milton presented between September of 1977 and May of 1978 fifteen public lectures before various audiences followed by question-and-answer sessions, all of which were videotaped. William Jovanovich committed Harcou Brace Jovanovich to the marketing of the videotapes and provided a generous advance to help financ the videotaping of the lectures, which are currently being distributed by Harcourt Brace Jovanovich, Inc. The transcripts of the lectures served as raw material for designing the TV programs themselves

Before the lectures were completed, Bob Chitester had succeeded in obtaining sufficient financi ~~support to permit us to proceed with the TV series. We selected Video-Arts of London as the best~~ group to produce it. After months of preliminary planning, actual filming began in March of 1978 an was not completed until September of 1979.

Anthony Jay, Michael Peacock, and Robert Reid of Video-Arts played a key role in the initial design of the series and an important supervisory role thereafter.

Five TV professionals were with us throughout most of the filming and editing: Michael Lathan as producer of the series; Graham Massey, as film director; Eben Wilson, as an associate producer an principal researcher; Margaret Young, as assistant film director and production secretary; and Jackie Warner, as production manager. They initiated us gently but firmly into the arcane art of making TV documentaries and smoothed over the difficult spots with invariable tact and friendship. They made our venture into a strange and complex world an exciting and enjoyable experience rather than the nightmare that we now realize it could easily have become.

Their insistence on combining brevity with both rigor and lucidity forced us to rethink many of our own ideas and to pare them down to essentials. The discussions with them, as well as with the fil crews from different countries—one of the most enjoyable parts of the project—helped us to recognize weak points in our reasoning and induced us to search for further evidence. Released from the rigid time constraints of TV, we have been able to take full advantage of these discussions in this book.

We are in debt to Edward C. Banfield and David D. Friedman, who read the complete first draft, and to George Stigler, Aaron Director, Chiaki Nishiyama, Colin Campbell, and Anna Schwartz. Rosemary Campbell spent many hours of painstaking work in the library checking facts and figures. We cannot blame her if errors do appear, for we did some of the checking ourselves. We owe much t Gloria Valentine, Milton's secretary, whose good nature is matched by her competence. Finally, we appreciate the help we have received from Harcourt Brace Jovanovich, some anonymously, some fro William Jovanovich, Carol Hill, and our editor, Peggy Brooks.

Television is dramatic. It appeals to the emotions. It captures your attention. Yet, we remain of the opinion that the printed page is a more effective instrument for both education and persuasion. Th authors of a book can explore issues deeply—without being limited by the ticking clock. The reader can stop and think, turn the pages back without being diverted by the emotional appeal of the scenes moving relentlessly across his television screen.

Anyone who is persuaded in one evening (or even ten one-hour 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 Friedma
Rose D. Friedma
Ely, Vermo
September 28, 197

"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 w 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 hol 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. 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 th 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. Eve 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 tha 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 wa 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 concentrate power that endangered the ordinary man. The other side of that coin was that it possessed little powe 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 strong government. Instead, they were attracted by the good that a stronger government could achiev —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 ha 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 ha 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 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 paw buffeted by forces beyond his control. The view that government's role is to serve as an umpire to prevent individuals from coercing one another was replaced by the view that government's role is to serve as a parent charged with the duty of coercing some to aid others.

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

These developments have been produced by good intentions with a major assist from self-interest. Even the strongest supporters of the welfare and paternal state agree that the results have been disappointing. In the government sphere, as in the market, there seems to be an invisible hand, but it operates in precisely the opposite direction from Adam Smith's: an individual who intends only to serve the public interest by fostering government intervention is "led by an invisible hand to promote" private interests, "which was no part of his intention." That conclusion is driven home agai and ~~again as we examine, in the chapters that follow, the several areas in which government pow~~er ha been exercised—whether to achieve security (Chapter 4) or equality (Chapter 5), to promote educatio (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 effect 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 w continue to grant ever more power to government, to authorize a "new class" of civil servants to spen 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 t 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 w 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 experiencin 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 oth extreme of total collectivism.

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

CHAPTER 1

The Power of the Market

Every day each of us uses innumerable goods and services—to eat, to wear, to shelter us from the elements, or simply to enjoy. We take it for granted that they will be available when we want to buy them. We never stop to think how many people have played a part in one way or another in providing those goods and services. We never ask ourselves how it is that the corner grocery store—or nowadays, supermarket—has the items on its shelves that we want to buy, how it is that most of us ar 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 coordinatin 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 i 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 mor 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 comman —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 market 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 o 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 th 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 ma 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 th 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 prosperit 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 vividl 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 ho to make me*." Then he proceeds to tell about all the things that go into the making of a pencil. First, th 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, wher 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 h 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 littl 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 ha one another—yet none of these differences prevented them from cooperating to produce a pencil. Ho 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 difficu to understand how it can enable people living all over the world to cooperate to promote their separat 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 o millions of people, each seeking his own interest, in such a way as to make everyone better off. It wa 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 i 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 t 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 a 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. Th 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, the 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 on 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 pric system automatically solves this problem. The people who transmit the information have an incentiv 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 ca 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 organize 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 particula 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 informat~~ion. 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. 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 internationa 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—th 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 o 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 wo~~od 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 pric 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 ha an incentive to shift from the one to the other. The most obvious examples are shifts from large cars 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 b the greater demand for wood as a substitute source of energy, the resulting higher price of lead penci 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 woo 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 becom loggers. More young people entering the labor market may become loggers. Here, too, interference b government, through minimum wages, for example, or by trade unions, through restricting entry, ma distort the information transmitted or may prevent individuals from freely acting on that informatio (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—wha 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 th entrepreneur—like the manufacturer of pencils—is different in form but not in substance. His incom 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 owner —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 th 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 coul 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 t 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 an mental capacities. Chance determines the kind of family and cultural environment into which we are sample content of Free to Choose: A Personal Statement

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