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The title of this session, “The Economic Responsibility of Government,” reminds me of an ancient story that I think is relevant. It has to do with a couple of youngsters from the boondocks (maybe from College Station or Bryan) who came to New York for the first time. They had never been to a big city and they were awed with the great metropolis. After a week in New York, on their last day, they were trying to work up the courage to have dinner in a really fancy New York restaurant. (Maybe it was Sardi’s or the Club 21.) They walked back and forth outside the restaurant before they got up enough courage. They ordered dinner, including soup, an entree, dessert, and coffee and then the waiter brought them finger bowls. The first one looked at the other and said, “What do you suppose that thing is?” The second one said, “Gee, I don’t know. It can’t be soup, we already had soup.” The first one said, “Well, it can’t be a drink, we just had some coffee.” The second one said, “I’m going to ask the waiter.” The first one said, “Oh no, no. He’ll think we’re hicks.” But his friend insisted, “No, I’m going to ask the waiter.” So they called the waiter over and asked him what the fancy bowls with the clear liquid were for and the waiter said, “Well, of course, that’s to wash your fingers in.” As the waiter went away, the first one looked triumphantly at his friend and he said, “You see, you ask a foolish question and you get a foolish answer.”

That is the same problem with the title of this session. Government has no economic responsibility. Only people have responsibility and the government is not a person. The notion

that government has a responsibility sends one looking for an answer in the wrong direction, because it suggests that government is a collective entity. It promotes the idea that there is something over and above the millions of individuals who constitute the society.

The right question, in my opinion, is a very different one. It is not, “What are the economic or other responsibilities of government?” It is rather, “What things do we want to do through government?” Government is an instrumentality, it is the means that we use to achieve our objectives. Consequently, the important questions are: How do we use it effectively? For what do we use it? How do we keep it from becoming our master?

The notion of government as a collectivity has unfortunately been all too dominant throughout history. It is a notion that has destroyed freedom in many parts of the world. It has not done so here in the United States and we trust that it will not. But I believe that it will contribute to our keeping government in its proper role if we think of it in the right way. Sometimes it is difficult to do so. The people who are employed in government, civil servants, the people who sit behind those millions of desks, are supposed to be our servants. But when they call you in to question you about your income tax return, or to discuss whether you are obeying the OSHA regulations, I doubt very much that you feel that you are the master.

What do we want to do through government? What are the things that we believe we can accomplish better through political arrangements, through governmental structures, than we can through our separate voluntary cooperative efforts? If we look at the traditional functions assigned to government in the United States, they are very straightforward. The central function we have always tended to assign to government is to preserve law and order; to keep one man from coercing his fellow man, to keep a person from hitting his neighbor over the head with a blunt instrument. Second, we expect the government to protect the nation against foreign enemies, to provide for the national defense. Third, through legislative and similar means, we want our government to establish a framework of rules under which we operate, and to enforce contracts that we voluntarily enter into with one another. Fourth, we ask the government to

provide a judiciary that can settle any disputes or disagreements that may arise. Fifth, we commission the government to provide a common medium of exchange, to provide a monetary system. Finally, a paternalistic element, we want our government to provide for people who cannot take care of themselves — people who are in dire distress. These are the traditional functions of government.

What has been happening in the past fifty years is that we have been expanding very greatly the role of government. We have been having it undertake a wider and wider range of activities, particularly in the two final areas: in the area of monetary and economic controls, including governmental regulation, and in the area of paternalistic activities. One of the most interesting phenomena is that as government has expanded its scope by undertaking a wider range of activities — activities that were never traditionally a part of the functions we assigned to government — it has performed its traditional functions of preserving law and order and keeping a framework for a decent society less and less well.

I want to discuss the expansion of governmental activities, particularly in the monetary area and the paternalistic area; but I want to note first the extraordinary importance of the traditional functions, the functions of preserving law and order, of establishing a framework of rules, and so on. Those functions are crucial to the economic health and development of a nation. You may ask why I should be discussing those functions under the heading of the “economic” responsibility of government. Economic progress is not possible anywhere — anywhere in the world or at any time — unless there is a relatively stable structure of law and a reasonable degree of security of person and property. If there is a complete insecurity of person and property, economic growth and progress are impossible. That has been demonstrated over and over again. On the other hand, if there is a reasonable degree of security of person and property, if people can be assured that they will benefit from their own activities, that if they acquire something, it cannot be taken away from them by force or other means, they will work to acquire that property. So, a very essential

precondition for any kind of satisfactory economic progress is security and stability of person and property which have been the traditional functions of government in the United States.

Having stated those preconditions, I want to spend most of my time on a discussion of the areas in which government has been expanding its role in recent decades in directions which seem to me to have been very unsatisfactory and unsuccessful. The provision of a money supply is a traditional function. You all recall from your history courses that the U.S. Constitution provides that Congress shall have the power and I quote, “to coin money, regulate the value thereof, and of foreign coin.” Now of course, that specification, “to coin money, regulate the value thereof, and of foreign coin,” when it was first introduced, meant a very different thing from what it has come to mean. It has expanded enormously. The first great expansion came during the Civil War, over a hundred years ago, when the federal government issued paper money, which came to be called “greenbacks,” to pay part of the cost of the Civil War.

One of the most amusing incidents of that whole venture involved a man named Salmon P. Chase who was the Secretary of the Treasury at the time of the Civil War. As the Secretary of the Treasury, he was responsible for the issuing of greenbacks. Some ten years or so later he was the Chief Justice of the Supreme Court of the United States when the first of the famous “greenback” cases, *Hepburn v. Griswold*, was brought before it. At issue was the question of whether it was or was not constitutional for him in his capacity as Secretary of the Treasury to have issued the greenbacks. Not only did he not disqualify himself from the case, but he voted with the majority that it had been unconstitutional for him to do what he did. That gave rise to the first episode of court packing. The decision was one that those in power could not tolerate, so they expanded the size of the Supreme Court from seven to the present nine members and appointed two new members. Fourteen months later in the case of *Knox v. Lee*, Salmon Chase voted the same way as before, but he was in the minority this time. That was the constitutional authority for the printing of “greenbacks.”

Since 1871, that function has been expanded enormously; not only to the provision of a medium of exchange, not only to the regulation and control of commercial banks, the establishment of the Federal Reserve System, and so on, but also to the idea that it would be possible for government to promote economic stability through fine-tuning monetary magnitudes and fiscal magnitudes. That development has not been peculiar to the United States; it has occurred throughout the world. It was a reaction to the great depression of 1929 to 1933 — a catastrophe that was wrongly, in my opinion, attributed to a failure of the capitalist system. The Depression was not a failure of capitalism. It was a failure of government policy and management. The Great Depression was produced by the mistakes that the Federal Reserve Board made in permitting the quantity of money to decline by one-third. Nonetheless, it stimulated the belief that government had to be in there manipulating these dials so as to promote economic stability, full employment, stable prices, and the whole other litany of fine objectives. The results have been very different from the hopes that were placed in these mechanisms.

Instead of a period of economic stability, we have had a period of ups and downs, of gradually rising inflation, of instability, of what now has come to be known by the unlovely name of “stagflation.”

Increasingly in the post war period, the experience has been that inflation has risen and fallen. We have had a roller-coaster ride about a long-term upward trend of inflation. We have had a roller-coaster ride about an upward trend in the levels of unemployment. And in recent years, even more seriously, we have had a definite reduction in the rate of economic growth. I don't want to attribute all those results to the idea of fine-tuning the economy or to countercyclical monetary and fiscal policy in particular. I believe that the growth in the size of the government — in government spending and government regulation — and the disincentive effects on business investments have had much more to do with the slowdown in economic growth and the declining productivity growth than has monetary and fiscal policy itself, or indeed than inflation. Nevertheless, we have tried hard to stabilize the economy, and the results have been very

disappointing. I believe that economists as a group have done a great deal of harm to society by promising too much. We have believed that we knew the secret of how to manipulate government spending and monetary flows in such a way as to keep everything on an even keel. Again, that is not specific to the United States; the experience is the same in Great Britain and many of the countries of the world.

I turn from that to another governmental activity that has expanded enormously: the paternalistic function of taking care of the irresponsible. That function, at one time exercised primarily by local governments, by local communities, with a great deal of private charitable activity as well, has been expanded enormously. It has been the most rapidly expanding area of government spending — particularly in the past two decades. Total spending on various programs supposed to redistribute income, supposed to eliminate poverty, supposed to transfer income to the needy, has grown by leaps and bounds. Ten years ago, the national defense budget in this country was one-and-a-half times as large as the budget of the Department of Health, Education and Welfare. Currently, the two component parts of HEW, the new department of Education and the Department of Health and Human Services, have a budget that is one-and-a-half times the total military budget. Those are the programs that have grown. Spending on national defense has gone down from something like eight percent of the national income to five percent of the national income. At the same time, spending on the transfer programs and the HEW type programs has gone in the opposite direction. The objectives of these programs have been noble. Helping the poor, providing a wider range of opportunity, making it possible for people to further their objectives more effectively, those objectives have all been noble, but the results, in my opinion, have been ignoble. The results, in my opinion, have been the opposite of those that have been intended by the well-meaning proponents of such programs.

I have been very much impressed by some of the reactions that we have gotten in this connection to our TV program “Free to Choose.” The reaction of the public-at-large to that program has been fascinating in many ways. I may say on the whole it has been extremely

favorable, and I suggest there is a much wider constituency within the broader body politic for the view that government has gone too far and should be cut back in size than one might suppose. But what I want to refer to now are not those favorable reactions, but a small minority of very vitriolic and negative reactions. And they all have one common component. They all sound the theme, “You are heartless, you have no sympathy for humankind, you want to grind the poor under your heels.”

Let me quote from one such letter, just to show you the flavor. “Your viewpoints, reminiscent of Queen Antoinette, the Russian Czars, Nero, and worse, are the most animalistically inhumane I have ever heard.” Well, that was a nice pat on the back.

Why do I cite it? Because it seems to me to bring out very clearly what is the key point of confusion: the confusion between objectives on the one hand and results on the other. Here we have a very wide range of governmental programs which supposedly are intended to help the poor. In fact, almost every single one of them has the opposite effect. They impose burdens on the poor in order to benefit middle and upper classes. Which is more inhumane? Which is more humane? Is it more humane to promote the fiction, to object to people who try to uncover that fiction, who try to show what is actually happening despite the good intentions? Or is it more humane to uncover the fiction and try to bring out the facts and to explain what is actually going on?

My objection to these governmental programs has nothing to do with the objectives of many of the well-meaning people who promote them. My objection has to do with the consequences they have actually had. I do not believe that those consequences arise because the people who administer the programs are evil, or because the people who designed them are evil, or because anybody intends the programs to go astray. Those perverse results arise, I think, from a much more fundamental feature. And that fundamental feature is that you cannot achieve good objectives by bad means.

The means of trying to finance these large scale redistributive programs involve coercion; they involve people using some force to take money from other people for the benefit of still third parties. Nobody spends somebody else's money as carefully as he spends his own. The one thing you can count on everybody to do is to put his interest above yours. *That* you can really count on people to do. The fundamentally good objectives of these programs are flawed by what I regard as the fundamentally bad means that are used, the means of force and coercion. Now I do not want to continue on that abstract level; I want to use the little time I have left to get down to cases and say exactly what I mean. And here is where some of you may be a little disturbed, because I want to start right here at home, at Texas A&M, with the problem of financing higher education.

No governmental program that I know is so clearly perverse in its redistributive aspects, so clearly imposes burdens on low income people for the benefit of middle and upper income people. Let me hasten to add that this is not a criticism of any individual. I, myself, am a beneficiary of such a perverse program. I went to college with a scholarship that was granted by the state of New Jersey. I happen to think it was a good thing that I went to college (though there are many people who do not think so). But the day after I got my Bachelor's degree, I left New Jersey and I have hardly ever been back since. I don't know what the people of New Jersey got out of it, but I do know what I got out of it. I got the opportunity to have a much higher income than most of the people who paid the taxes. I should have paid for that education, not they.

Consider any one of our institutions of higher education being financed by the state. The budget of Texas A&M University, I am told, is somewhere in the neighborhood of \$250 million of which, I understand, \$200 million or so comes from state or federal tax funds. You have an excellent student body here — fine, highly motivated people. Your performance is very high compared to most state universities. I have been inquiring about that; I make it a hobby to find out what the ratio of graduates is to entrants. At the University of California at Los Angeles it is fifty percent, and that is one of the good state universities. Here I am told it is up in the sixty-five to seventy percent range, which is a very high ratio. So I am not criticizing the performance, but I

want you to look at the equity of it. Ask yourself what average income the students who graduate from this university will have and what average income the people who pay taxes to send them to this university will have. Is there any doubt what the answer is? The average income of the people who pay taxes is vastly lower than the average income of the families from which the students come and it will be lower than the income these students will have in their later years. Try to justify that on equity grounds. And I believe there are no other grounds on which it can be justified.

The major beneficiaries of higher education are those of us who get the education, the students including me and others who got a tax-subsidized education. We are the ones who benefit most. We hope society benefits also — that would be nice; but that is not a reason for imposing burdens on low income people. We in the middle and upper income classes have been able to con the poor suckers at the bottom (and ourselves as well) into believing that it is all right for us to be subsidized at their expense. I believe that every young person who has the ability and desire should be able to go to a university — *provided* he is willing to pay for it, either at the time he attends or subsequently out of the higher income which he will earn. Again, this phenomenon is not peculiar to Texas. It occurs in every state in this country. And the argument holds for the funds that are provided both at the federal and the state level. That is one example.

Having struck at one sacred cow, let me strike at another — social security. Here is another example where we in the middle classes have conned the lower income classes into supporting us. How could I make such an outrageous statement? Simply because it is true. Let me suggest why it is true. Let me ask the question: at what age do young people from lower income classes go to work? They will tend to go to work at the age of sixteen or seventeen — eighteen at the latest. And they will start paying taxes immediately. At what age do the children of middle income parents go to work? Well, we are lucky if they are self-supporting by age twenty-five. When they do go to work, they start to pay social security taxes at that time. So the people from the lower income classes pay taxes for more years than the people from the upper income classes. That

alone, if you do your arithmetic at any reasonable rate of interest, suggests that they are bearing a heavier burden. But it is even worse if you look at the other end. All of the statistics show that people in lower income classes live shorter lives than those from upper income groups. So if we qualify for Social Security benefits, we shall receive benefits for a greater number of years on the average than those in the lower income classes. The net effect of that difference in the number of years in paying taxes and the difference in the number of years receiving benefits more than counterbalances the specific provisions that are supposedly designed to benefit low income persons.

Let me hasten to add that again I am not criticizing any individual, I would not hesitate to take the social security benefits if I qualified for them. (I am over sixty-five; but, because my earned income is above the specified minimum, I do not get any social security benefits though I continue to pay the social security taxes.) We must distinguish two very different things: What is proper social policy (what we as citizens recommend and try to get enacted into law) and what it is proper for us as individuals to do, given the set of rules under which we live. If our legislators are so foolish as to enact such measures, there is nothing wrong in any individual's obeying the law and benefiting from it. Again, I am not proposing an overnight stop to this. Take social security: I am not in favor of going back on any agreements we have made, any obligations we have assumed to people. But I am in favor of modifying the program from this day on so we don't assume any more obligations.

There is almost no program that I know of, enacted under the name of helping the poor, redistributing income, that is not perverse in this way. The only one that comes even close is direct welfare (aid to dependent children and the rest). And even that is by no means clear. In the first place under those programs there are many people receiving assistance who by no stretch of the imagination can be regarded as being in need. Moreover, you have to look at the funds that are siphoned off by the very large welfare bureaucracy. That bureaucracy has provided a large number of good jobs with high salaries for well-meaning people.

I have often challenged audiences to name a significant program of governmental reform intended to distribute income from high to low income, which succeeds in so doing. Almost every one that I know of has the opposite effect. I hasten to add that this is a complex matter. Frequently, the very highest income groups and the very poorest groups lose while the middle and upper-middle income groups gain. The groups at the bottom lose because they are politically ineffective, in general. The wealthiest groups lose because they offer such a nice, tempting prize to be exploited.

Let me close by saying that in the late 1930s after the noble experiment of prohibition had demonstrated that it was an utter failure, this nation had sense enough to discontinue the experiment and repeal the Eighteenth Amendment. We now have had a series of noble experiments: the new deal, the fair deal, the great society. These experiments have failed, in my opinion, to achieve the hopes and the aims and the objectives of the people who promoted them so enthusiastically. The question is this: will our society have the will and the sense to disband those aspects of those programs that have become a failure? I am, myself, optimistic — not from a short run point of view — but from a long run point of view. There is a widespread disillusionment with the proposition that the way to solve every problem is to throw somebody else's money at it. There is a widening recognition on the part of the public that we need measures that will cut government down to size. The so-called tax revolt is very real in my opinion. I am encouraged by the number of states which have adopted constitutional amendments to limit spending by state governments. I am encouraged by the strength of the popular will behind the corresponding constitutional amendment at the federal level to limit federal spending. It is even encouraging to hear all the lip service that is being paid in Washington to the idea of cutting down the size of government and of balancing the budget — even though it is only lip service. Even though the programs that are proposed are, in my opinion, ill-suited to achieve the stated objective, it is clear that the problem has been recognized. There is an old saying that hypocrisy is the tribute which vice pays to virtue. The hypocritical statements emanating from

Washington about the desire to reduce government spending are the tribute which is being paid to the widening and broadening sentiment on the public at large. This is a democracy; and sooner or later the will of the voters will prevail, so I am optimistic that we shall learn from our experience and correct our errors.

Questions and Answers

The first question was for Professor Friedman: “Do you believe that maintaining a money supply directly related to the gold supply in public treasuries is a workable method of monetary control?”

Professor Friedman: When dealing with this particular question, one must ask what is meant by workable? On a purely technical level, of course, it is possible to control the money supply by linking it to the gold supply in the treasury. The deeper question, however, is whether it is desirable to do so. A real honest-to-God gold standard under the conditions of the nineteenth century had a great deal to be said for it. I do not believe that it is a desirable method of controlling the money supply under current conditions — under conditions where you have government that absorbs a very much larger fraction of the income, under conditions where no government is willing to let its policy be dictated by the needs of preserving a fixed ratio of its currency to gold. South Africa does not find it appropriate to have an honest-to-God gold standard. And there is no country in the world, in my opinion, that today either would adopt or would be well advised to adopt such a straightforward gold standard. I regret having to say that. I would like to say the opposite. It would be nice to be able to be in favor of an automatic gold standard, but I frankly cannot see it operating effectively under present circumstances.

The second question was for Professor Samuelson: “How should the government fine-tune our economy today? Tax increases, budget controls? Why aren’t these measures being taken?”

Professor Samuelson: Well, fine-tuning is an epithet, so my answer is that I abjure fine-tuning. I think that the debate may be put on whether the state of our knowledge of the future is

such that the best rule to follow is in-season and out-of-season to do the same thing, as against using the best information that is available to us and the best ways of analyzing that information, to engage on occasion (on judicious occasion) in stabilizing behavior. Now let me say something that I believe can be documented; I do not, myself, perceive the greatest difficulties in stabilization policy to be our lack of forecasting ability. My wife and I made a trip in March of 1973 all through the Pacific and when we came back, I was astonished to learn that the ablest of the consensus forecasters were saying that the long expansion is coming to an end and there is going to be a recession. I was out of date. It did not seem likely to me. But within a couple of months, the whole pack had correctly sensed the change. The actual recession is dated by the National Bureau of Economic Research as coming in November of 1973, a doubtful timing in my judgment, but the real virulence of the recession wasn't until a great deal later. So all this time, like Cassandra, we were moving toward it, and essentially knowing that we were moving toward it. Twenty-three out of twenty-eight of the economists called by President Ford to the White House in September, 1974, were in the right direction in this respect, but that recession was not an unwilling recession. I said at the time, I said afterward, I say now of the next recession, if you turn it over on its bottom and read it carefully, it says "made in Washington." Now that's not because the Washington people are more stupid than those of us in academia, or in New York, or in Dallas. It's not because they are cruel; it's not because they want to lose votes; it's because, given our situation of stagflation, there is no jury of twelve expert economists who can agree on an incomes policy, who can agree on a therapy for the stagflation disease which we have, which does not involve a business cycle phase like that of the present or that of 1973-74 — a contrived slow-down in the economy. Well, I do not want to go on and argue the point because it certainly is arguable and debatable, but I think that the record by my reading and by my understanding of the principles of optimal control, will say that if you try to fine-tune the economy, try to make everything perfect, you will not succeed and you will probably make things worse, but that there is a middle ground between trying to do that and using a mode which in optimal control theory is

optimal only under extreme circumstances — namely, to do absolutely nothing except follow a steady increase in the money supply at a certain stipulated rate. Now that has been, and is, the bone of contention between Professor Friedman and me over the years.

The next question was for both speakers: “What do you think will be the short- and long-run impact upon employment and inflation of President Carter’s proposal to balance the budget?”

And following that, “What do you think is the probability that the budget actually will be balanced?”

Professor Friedman: Let me begin by taking up the point that Paul quite properly specified as the bone of contention between us. He is quite right in describing it, and I only want to say a few words about why, despite his admirable arguments and persuasive manner, I come down on the other side. First there is the fact that you have to look not to 1973 but to 1972 and 1971 and ask where the problems came from, which led to the recession of 1974-75. The answer is it came from the relaxation of monetary restraint. That is to say, the attempts by government to move in countercyclical directions made matters worse. In 1973 and 1974, Paul and I were on the same side of the issue about what the Federal Reserve should be doing, because if you believe as I do that the Federal Reserve ought to keep the money supply growing steadily, then every once in a while, those who want to increase and decrease its growth rate come to the same rate as I come to. So the first point I would make is that the fine tuning gets us into the problems, and then we follow with an attempt to get out.

The second point is that even if we knew how to take that middle ground to avoid detailed fine tuning, political considerations would force us to do something different. That is to say, even if we had Paul Samuelson turning the dials (and I agree that would be a great deal better than what we’ve had), the truth is that he wouldn’t be permitted to do what he wanted to do. It is not conceivable that economic considerations would be permitted really to control how Paul tuned those dials. Political considerations would take over and would prevent him from taking what he and I might agree was the correct action.

The third point is the most fundamental. I believe that a system in which the public-at-large knows that there is a stable monetary policy on which it can depend, a policy for which there are rules specified in advance so it knows what to expect, that system will have operating characteristics that are quite different from those of a discretionary system that follows exactly the same policy. It would not be as good to have the Federal Reserve, let us say, agree secretly that they were going to maintain a steady growth in the money supply as to have a public announcement to that effect. What is very essential, it seems to me, is stability in expectations. Those are the three reasons why we come out on different sides of this bone of contention.

Now to turn to the question that was asked. I do not believe that balancing the budget is the key problem. The budget at the federal level is always balanced. If the federal government spends \$600 billion and takes in what are labeled taxes amounting to \$550 billion, who do you suppose pays that other \$50 billion? Is there some Santa Claus out there, some tooth fairy? You and I pay it; it's a form of taxation through either inflation or some other indirect means. So from my point of view, the crucial problem is not whether you balance the budget, but how. President Carter proposes to balance the budget by increasing taxes, not by reducing spending. There are already on the books tax increases scheduled to amount to something like \$50 billion or more by 1981 (in the form of already legislated increases in social security taxes, the mislabeled windfall profits tax which is really an excise tax on oil, and the automatic increase in the level of tax rates which arises through inflation's pushing people up into higher brackets and increasing the effective rate of the corporate income tax). In addition, President Carter is proposing still further increases in taxes in energy and on credit. The combination of those effects will be, if they are carried out, a very substantial increase in taxation. In my opinion, that is a very undesirable measure, and therefore I find the President's program counterproductive.

As to the question of whether the budget ever will be balanced, yes. It will be balanced; it is *always* balanced. That isn't the problem. That is again asking the wrong question. I would far rather have a federal government budget of \$400 billion with what the accountants call a hundred

billion dollar deficit than to have a federal budget of \$600 billion that was perfectly balanced. But I am not going to forecast whether the accountants will say it is balanced or not; that is a different question. Over to you, Paul.

Professor Samuelson: Well, let me say that if the President reduces the deficit by \$15 billion, or something more than that (that is most of what is being talked about), we are talking about an amount which is less than one percent of the total GNP. And if you take all the levels of government, and calculate what the accountants call the deficit and what the rest of us call the deficit, you will find that all three levels of government are in surplus. Part of the reason for that is the inflation itself which has been generating a great amount of income. But I think it is very important, both in terms of expectations and in terms of continuation of monetary policy, whether or not the administration does seek seriously to fight inflation by creating some slack in the system and tolerating an actual recession. Nobody has asked the question yet (but I'm sure that they will). Will there be a recession? Economists, generally of all persuasions (I have tallied monetarists on this subject, and I have tallied the other kind), all have been saying since about April Fool's Day, 1979, that we are about to be in a recession. I believe that with the price level rising at something like eighteen percent a year, we are certainly in a growth recession or a mini-recession now. Output is not growing very much. If the monetary aggregates are kept anywhere near where they have been kept recently, the prime rate will soon be twenty percent. I mentioned in my *Newsweek* column that I ran into a chap with a fair-sized leasing business who is paying 29% for his money. It will not take very long at that rate on any version of money theory for a recession to take place.

Now it is very important to Europeans and to the rest of us whether that is the serious intention, and it is in that light that I think you would have to regard this rather symbolic gesture of moving closer towards balance of the budget.

The next questioner asked for the speakers' comments on a statement made by Senator Kennedy: "We need to freeze prices across the board to break the psychology of inflation."

Professor Friedman: We need to break the psychology of inflation, but there is only one way to break the psychology of inflation and that is by breaking the policy of inflation. I believe that freezing prices and wages across the board would be highly counterproductive. There is a recent, very interesting book by Robert Schuettinger and Eamoun Butler called *Forty Centuries of Wage and Price Control: How Not to Fight Inflation*. Think of it — 4,000 years! I don't think you can find a successful example of price and wage control in those 4,000 years in the sense that such a policy was able to stop an inflation. If they work at all, they serve only to interrupt it briefly, after which you are off on the same inflation path as before. We tried controls in this country as recently as 1971. I certainly hope we are not subjected to them again.

Professor Samuelson: Senator Kennedy paid me the compliment of asking my views. I gave him an unsparing appraisal of different policies, and this is what I had to say about mandatory wage price controls. I don't go back 4,000 years; I only go back 40 years and tally the experience during war time of a number of countries. Since the end of World War II, about 15 different mixed economies including Finland, Holland, the U.K., France, Japan, and ourselves, had two or three bouts of mandatory price control programs. Now I am not a great admirer of the Harvard Business school case method, but there are times when cases are in point. I have been trying to get my neighbor from down the river, John Kenneth Galbraith, to give me his reading of these thirty to sixty cases and how they worked out. In my reading, the preponderance of the experience comes down to the following: for six or eight months, they will deliver, in large part, what the constituents who ask for them hope for (although the later we are in the century the less they are even going to do that). But they are definitely a short-run measure and, after that very short period (short in terms of human history and short in terms of the length of the future), they become inequitable and ineffective. The bureaucracy that enforces them grows, and much that you seemed to gain, you begin to lose. If we fail to remove them in time, we may lose everything that we have gained and even more than that. Now there are times when a six to eight month fix would be a very desirable thing for society; but once you've used this up, you've used it up until

another half dozen years have gone by. You can't use it again. In my opinion, there is nothing special about the intensification of the inflation at this time. It is part and parcel of a chronic stagflation condition which we and the other fifteen mixed economies have been going through, and there is not even the merit in the situation that there might have been in August of 1971.

(Incidentally, it was a local non-economist named John Connally who was the origin of the 1971 price controls. If Mr. Nixon had never imposed price and wage controls, we might not now have price controls on crude oil, and we would not have the kind of energy crisis we have now.)

The next question was for Professor Friedman: "Would you please comment about government sponsored research? Do organizations like the National Science Foundation have a viable place in government? Should their functions be increased or decreased?"

Professor Friedman: That is not one of those questions which you can answer completely immediately off the bat. It is not one of those in which principle alone will suggest an answer. And the reason is because it is not feasible to submit certain kinds of research to market controls. That is to say, the person who invents something, who discovers something, is not in a position to capture the return from such a discovery. And therefore, there is a case for saying that it might be appropriate to have governmental sources of funds to subsidize research. However, I have thought a great deal about that particular issue, and I have come to the conclusion that there is no justification for the National Science Foundation.

While it is not, as I say a *prima facie* case, if you look a little bit more carefully at the situation, you will discover that there are other non-market means for financing basic research. I have come to the conclusion that on the whole there is no evidence that those other non-market means would be inadequate.

Let me give you the main non-market means that is available. Universities are complex entities and generally (let me speak for a moment of universities like my own and Paul's, private universities) they are in the business of selling three products: they are selling schooling; they are selling research; and they are selling monuments. And the monuments are in the form, for

example, of the Regenstein library at the University of Chicago. I don't know what the counterpart is, but every major university, including Texas A&M, is in the business of getting private philanthropists to subsidize basic research. Private philanthropists are willing to do it. This is, in effect, an industry. Monuments can be sold precisely because no effective way of selling this research on the market is available. After all, nobody would regard it as a monument to Mr. Smith to construct the Smith building at the Smith factory. That's a commercial venture, the factory. But it is a monument to him to construct a non-commercial building — the Smith library or the Smith laboratory — or to endow the Smith fund for biological research at the XYZ University precisely because that is clearly not a commercial venture which is being pursued for commercial purposes. Now on the other side when you have government provide these funds, it is not being done voluntarily. It is being done under circumstances where you are inevitably going to have control follow the grant of the funds. Almost all of these things work well when the new broom sweeps clean. When you first start the National Science Foundation, political considerations don't enter in; you have peer review by scientists and so on. But in the course of time, it becomes clear that these grants ought to be spread pretty evenly among the states; political considerations inevitably come in, and the control over these funds becomes a way of promoting certain kinds of research and discouraging others.

So, on the whole, my own conclusion has been that society would be better off if we refrain from subsidizing things like the National Science Foundation. The National Endowment for the Humanities has even less justification. In fact, there is *no* justification that I can see for the National Endowment for the Humanities. There is no justification that I can see for the \$160 million a year that is being given to public broadcasting. I say that as a beneficiary, in part, but fair is fair. And so, on the whole, my answer to that question is, "No."

The following questions were asked by journalists present.

Representative of the Press: *Dr. Friedman, yesterday, we had occasion to interview the President's special assistant on consumer affairs, who recently, by virtue of her position, has*

been monitoring information on problems of inflation affecting consumers. She stated that one announcement to be made later this week would describe a program of voluntary price ceilings on drugs and generic items relating to chain drugstores. In your opinion, are these fine tuning measures? Are they constructive? What is their purpose?

Professor Friedman: They are not fine tuning measures at all. They are smoke-screen measures. They are trying to shift the buck. They are trying to blame other people. Inflation is made in Washington and nowhere else. It cannot be cured by voluntary or compulsory ceilings on prices of drug items. The actions of the administration are normal. All of us act the same way. Something goes wrong; it is never our fault. Somebody else is always to blame. Similarly, what you are reporting here is a great attempt by the administration to shift the blame from itself to other groups such as the retailers or drug manufacturers or the labor unions, or some other group out there rather than itself.

***Representative of the Press:** Dr. Samuelson, you were an influential advisor to Presidents Kennedy and Johnson. Referring to the programs that were discussed and the advice that was given over that period of several years, how are these programs most in evidence in our lives today?*

Professor Samuelson: Well, I cannot claim credit for the initiation of the poverty program. But in what proved to be the last years of President Kennedy's life, it was pointed out to him and to the other policy makers that although the country was moving again — the real disposable income was rising, the level of unemployment was falling — there still were pockets of poverty. Appalachia was a dramatic example. The economic advisors on the scene and some of us occasional visitors to Washington pointed it out. (If I might compare myself with Moses, I was an advisor to president-elect Kennedy, but it was not given to me to go into the promised land of actual rule.) And the poverty program, which was actually launched in President Kennedy's time, was taken over by President Johnson who tried to carry the ball. I am not the most sophisticated judge of human beings, but I thought that a very sincere strain in President Johnson came out.

Because he was a southerner and had a special feeling for what poverty had been among his neighbors in his youth, that effort was made. Now, like most efforts, it was imperfect in the execution.

***Representative of the Press:** Gentlemen, I have one final question that I would like to ask both of you. What do each of you believe is going to happen to the standard of living to the average American given the present rate of inflation?*

Professor Friedman: I believe it is a mistake to blame inflation for the change in the average standard of life. That is not true. What is true is that the change in the average standard of life that we have experienced over recent years has been a result of the declining growth in total output — the declining growth in total productivity. A climate of regulation and controls has tended to stifle capital formation, capital investment, and new initiative. Inflation has done a great deal of harm; but its harm is not so much, in my opinion, in lowering the average standard of life as in introducing an extremely arbitrary element into the division of the aggregate income among the various people in the country. The problem with inflation is that there are winners and there are losers. Some people are great beneficiaries from inflation. Everybody in this room who has owned a house has benefited from inflation. Some people are great losers from inflation. Everybody in this room who has bought US savings bonds or who has accumulated funds in savings banks or savings and loan associations has lost from inflation. The real harm which inflation does is to divide us. It is undermining the social fabric, setting people against people. But it is not the fundamental reason why you have a decline in the average standard of life.

Professor Samuelson: I don't believe that on the evidence the best bet for the last two decades of the twentieth century is that the standard of life which the American people enjoy will go down. The Club of Rome problem is a real problem. Modern industrial society does use up at a prodigious rate exhaustible resources laid down by nature in geologic time. My suspicion is that OPEC is given too much credit as a cartel in raising the price of oil, and that the true *competitive* price of oil, when we come to learn what its approximate level will be in history books years from

now, will turn out to be much higher than it was before 1973. But I believe that what this means is that instead of having what we have had in the past — about 2% per annum increase in living standards so that my living standard is higher than my uncle's and my uncle's is higher than his uncle's — that rate of growth will slow down. Part of the cause is the disincentive of affluence. If people are affluent, they do not want to work as hard and that is rational. Part of the productivity decline is spurious. If I have a cleaner environment, a better environment, and I really want it, that is good. Just because the measure we call the gross national product does not include environmental quality, that does not mean that quality of life is unimportant. Beyond that, I believe we historically had an advantage from our position in international trade as the leading country, with a consumer surplus as we economists say — and this probably will be somewhat undermined in time to come. Manufacturing, following the principle of comparative advantage, is beginning to leave the North American continent — and I believe that that is in accordance with economic law, not in defiance of economic law — and that may have a cost. It is not, in my view, an unhappy world prospect over the next twenty years even though neither we nor the world will repeat the miracle quarter of a century which just went by from 1945 to 1970.

Representative of the Press: I'd like to direct my question to both gentlemen. Is it inevitable that our economic system suffer a catastrophe in order for effective change to take place, and how close are we now to experiencing a catastrophe?

Professor Samuelson: Well, first, I think that often the changes that take place as a result of catastrophe are for the bad rather than for the good. It is a very dangerous kind of Swiss roulette to bring down avalanches in order to remove undesirable trees because more than those trees may be taken away. But beyond that, I don't believe a catastrophe is inevitable. The decline in real income which has been experienced by the American people over the last few years — I have to agree completely with Professor Friedman — is essentially a microeconomic event associated with the change in the terms of trade for energy and with the change in food prices. If the world had been run by the best nineteenth century standards, this reduction in productivity growth

would have shown itself by falling money wages and a stable price level. Inflation is what we blame because we think that the nine percent increase in earnings which we got was due to our merit and what took away the real fruits of that was the inflation. It was the declining growth rate of real production which took away those real fruits. We would not have gotten a nine percent increase across the board in nominal income if prices had been expected to be stable.

Professor Friedman: I have had experience over a long period that when you get a group of economists in a room, and you have also non-economists in that room, whatever may be the political ideology of the economists, in ten minutes the economists are all on the same side. And that is what is happening here when we have these questions asked; Paul and I come out on the same side over and over again.

Professor Samuelson: I would bet that *any* two persons in the same room with Milton Friedman for ten minutes will come out on the same side, at least temporarily.

Professor Friedman: Paul is much too generous. I really want to comment on this catastrophe thing from a different point of view, because I agree completely with what Paul has said about that. I think those people like Howard Ruff, Harry Browne, the other purveyors of doom and gloom are doing many people a great disservice. They are pointing to real trends and real problems in our society, but they lose a sense of proportion and they carry them beyond the reasonable point. In the process they scare lots of people and have them doing silly and foolish things. I got a letter a few years ago from a dental student of twenty-one. He was from Canada. Having just read one of these books — Harry Browne's or Ruff's, I don't know which one — he wanted to know whether he should take the bit of money he had saved up to pay for his dental courses and buy gold and food and get himself a cabin in the woods and hide himself there to sit out the coming catastrophe. That is a terrible thing to ask people to do. I have had letters, and I am sure Paul has had the same kind of letters from widows, women, men, of relatively modest means who are scared out of their wits by these tales of doom and gloom. We have real problems;

I believe we can solve them. I certainly agree that we do not need a catastrophe in order to solve our problems.