

WEEK OF NOVEMBER 20, 2006—UNENLIGHTENED SELF-INTEREST

The death of Nobel laureate Milton economist Friedman marks the passing of the greatest economic libertarian of the twentieth century, who never saw a government regulation he liked, or tax cut he disliked. He believed that financial markets were best left to function on their own, and a functioning economy only depended on an adequate supply of money in circulation.

One reviewer of his most famous book, “Free to Choose”, written with his wife Rose, summarized his extreme views. He was in favor of:

“the abolition of industrial regulation, security and exchange controls, farm price supports, minimum wages, public, national parks, compulsory military service, corporate income taxes, progression of income taxes,...the Federal Reserve System, licensing of physicians, and Social Security in its present form (i.e., not privatized),” according to the reviewer.

Dr. Friedman wanted to turn the clock back at least 200 years, in other words, to a simpler time that Adam Smith, founder of free market capitalism, called enlightened self-interest. Smith, a Scottish Professor of Moral Philosophy, believed people could best make financial decisions in their own self-interest (now termed rational expectations by classical economists), and in so doing benefit others as well. An ‘invisible hand’ would regulate market behavior, even though each person looked out for himself, so that there would be little need for government regulations.

Dr. Friedman’s answer to human misconduct was to lobby tirelessly for more scientific methodology in economic models, in order to take away economic decisions from governments and politicians. Such a utopian desire is characteristic of Dr. Friedman, particularly in his later years (though unrealistic).

Dr. Friedman’s contemporary opposite with whom he constantly clashed, was Keynesian economist John Kenneth Galbraith, another whose experience was shaped by the Depression. But Galbraith choose to take the side of government intervention in markets—he had worked in Roosevelt’s New Deal administration—since he believed that politics could not be separated from economics.

Even the Federal Reserve has been subject to political pressure. Many economists attribute the huge growth of consumer debt (and consequent real estate bubble) brought on by the Fed’s prolonged credit easing of 2001-04 to Alan Greenspan’s desire to help finance the current Bush administration’s tax cuts, for example.

Fellow Keynesian Robert Gordon epitomized Galbraith’s viewpoint in a 1971 AEA address: “...the distribution of these goods and services among potential claimants depends on much more than the operations of “impersonal market forces (my underline).” It reflects a complex of institutional arrangements, which include, among other things, the distribution of power among different groups to influence particular commodity and factor markets, how the ownership of wealth is distributed and for whose benefit it is used, the tax structure and network of government regulations that emerge

from the political process, and the total and distribution of net claims by the rest of the world against domestic output.”

In fact, today’s much more complicated economic world can be characterized as an era of unenlightened self-interest, and irrational expectations. Market bubbles can destroy a lifetime of savings, driven by investors’ irrational exuberance. Deregulation of whole industries such as broadcasting and telecommunications has resulted in the creation of oligarchies that control our airwaves while decreasing competition. And banking deregulation helped to create the Enron disaster.

More recent Nobel laureates, such as George Akerlof and Joseph Stiglitz (in 2001), convincingly argue that markets are very imperfect regulators of conduct, with insiders the greater beneficiaries and prone to an “infectious greed” as Alan Greenspan calls it that could actually discourage honesty. They must be regulated by such as the Federal Reserve and SEC in order for public confidence in markets to be retained.

Dr. Friedman’s greatest blindness was in not acknowledging that the practice of economics is political, as competing interests would pick and choose parts of the economic sciences that suited their interests. His neo-classical colleagues advocate so-called supply-side economics. And so they are loved by political conservatives who want more profits for large and small businesses (which in theory generates greater supply), via less regulation as well as tax cuts for corporations and stock holders. Keynesian economic theory was adopted by so-called liberals because of its focus on the demand side of the curve, which advocates policies that stimulate the greater growth of salaries and benefits for workers.

In fact, they are different sides of the same demand/supply coin. The 1970s era of stagflation gave too much to the demand side, allowing wages to start a wage-price spiral. Since 1980, supply-siders have taken the economic helm, bringing on the danger of deflation—too many goods being produced, or imported, with reduced incomes for 80 percent of American wage-earners, thus diminishing demand. The Economic Policy Institute, a labor think-tank ([www.epi.org](http://www.epi.org)), has documented the reversal—just 20 percent of corporate revenues have flowed to salaries and benefits during this recovery, whereas almost 80 percent flowed to employee salaries and benefits in past recoveries since World War II.

Therefore beware of those who would bring back Adam Smith’s world of 1776 (the publishing date of his “Wealth of Nations”). They forget his world was made up of small town markets where everyone was known, so regard for one’s good reputation was the first criteria for success, as well as a guard against fraud and deception. This was reinforced by a strong moral code and draconian laws of the time that even jailed debtors.

There are no such moral and ethical strictures on behavior today, or equivalent methods of ostracizing the miscreants. There can be enormous financial penalties (that may be paid from their stockholders’ pockets) and/or jail time, as with the Enron transgressors. But the hands that guide modern markets are no longer invisible, or self-regulating, or even benign. They are guided by very visible laws that must be administered impersonally, and carried out by government bureaucrats who have a vested interest in doing the best job they can to protect the public.