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FROM THE PAST TO THE FUTURE: IDEAS AND ACTIONS FOR A FREE SOCIETY

CHAPTER NINE

THE SPREAD OF FREE-MARKET IDEAS IN THE 1980S (WITH A NOD TO THE LATE 1970S)

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The Spread of Free-Market Ideas in the 1980s (With a Nod to the Late 1970s)

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> It started with Sir Keith [Joseph] and me, with the Centre for Policy Studies, and Lord Harris, at the Institute for Economic Affairs. Yes, it started with ideas, with beliefs. That's it. You must start with beliefs. Yes, always with beliefs.
> --Margaret Thatcher, quoted in Daniel Yergin and Joseph Stanislaw, *The Commanding Heights*, 1988, p. 124.

The Economic Setting and Some of the Results

The years from 1978 to the early 1980s were an exciting time for believers in liberty. Pro-freedom ideas were percolating in the United States, in the United Kingdom, and even, although we didn't know it then, in China.

Compare that to the early to mid 1970s. In the United States, a Republican president whom some in this Society, including me, worked for, imposed economy-wide price controls in 1971. Those controls were in force in 1973 when OPEC almost quadrupled the price of crude oil. The results were tremendous shortages of oil and gasoline, a central planning agency that allocated gasoline, and, under Presidents Ford and Carter, some serious intrusions into people's freedom to buy the kinds of cars and kitchen appliances they wanted. Although the price controls are long gone, those intrusions remain.

Marginal tax rates on individuals were high and rising as inflation put even middle-income people into tax brackets that had been reserved for very high-income people. In Britain, the top tax rate on "earned" income was 83 percent and on so-called "unearned" income was a whopping 98 percent. In the mid-1960s, the latter rate was 95 percent, a fact that led one of its victims, Beatle George Harrison, to write *Taxman* whose opening words got the marginal tax rate exactly right:

> Let me tell you how it will be
> There's one for you, nineteen for me
> 'Cause I'm the taxman, yeah, I'm the taxman.

In the United States, the top tax rate was 70 percent.

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But in the late 1970s, there was a growing movement in the United States and Britain to reduce tax rates. In the United States, economists such as Alfred Kahn and Murray Weidenbaum were critiquing government regulation and Kahn was chosen as head of the Civil Aeronautics Board, where he used his discretionary power to reduce regulation of airline routes and fares and used his persuasive powers to argue for legislation to deregulate airlines.

In both the United States and Britain, marginal tax rates at all income levels, but particularly at the top, were reduced in stages. Ronald Reagan, along with a bipartisan Congress, brought the top tax rate down from 70 percent to 50 percent and, later, to 28 percent. In Britain, Margaret Thatcher's government reduced the top rate on earned and unearned income to 60 percent and, later, to 40 percent.

In Britain, Prime Minister Margaret Thatcher, after winning reelection in a landslide in 1983, proceeded to take on the powerful strike-prone National Union of Miners, which had a monopoly on labor for the government-owned coal mines, and then to privatize a large number of government-owned firms and industries. By 1990, her last year as Prime Minister, for every thousand people working, only 108 work days were lost to strikes, a 93 percent drop from 1979 when she took office. By 1992, 46 major businesses, with 900,000 employees, had been privatized and, instead of draining taxpayer funds, were generating tax revenues.

In China, after the brutal dictator Mao Zedong's policies had killed tens of millions of people, the good news was that in 1976, he died. His successor, Deng Xiaoping, broke with Mao's socialist policies. Pushed by farmers protesting collectivist agricultural policies during a severe drought in 1978[2], he implemented reforms to let them keep more of what they produced. This gave the incentive to produce more. Later in the 1980s, Deng implemented economic reforms in the industrial sector that produced what he called "building of socialism with Chinese characteristics." That was a euphemism for an economy in which private property was more respected than it had been and people were freer to produce and keep a substantial portion of the proceeds from their production. The result was a few decades of high economic growth in which hundreds of millions of Chinese people were rescued from poverty.

The Intellectual Revolution

For policies to change, it is typically necessary for ideas to change. How did some of the key decision makers come to believe in freedom more than their predecessors did? There seem to have been two main ways. One is that those who didn't believe in freedom saw evidence that is so striking that they change their minds. The other is that they are persuaded on a more abstract level by those who believe in freedom and then start seeing confirming evidence in the world. Both are important.

[2] See Kate Zhou, *How the Farmers Changed China*, Westview Press, 1996. The title says it all, but the story is fascinating. Zhou gives credit where credit is due.

And both are what happened in large parts of the world to very influential people in the last 40 to 50 years. Daniel Yergin and Joseph Stanislaw, in their book *The Commanding Heights*[3], tell many of the stories. The subtitle carries much of the book's message: "The Battle Between Government and the Marketplace that is Remaking the Modern World."

Two important political players in Britain were Margaret Thatcher and Sir Keith Joseph. In the 1970s, they had both come to believe in economic freedom, partly from observing the low-growth, high-inflation mess that was the British economy and partly from reading. Three of the thinkers who inspired them were our founding member, Friedrich Hayek, and two other Mont Pelerin members, Ralph Harris and Arthur Seldon. Joseph, a member of the British Parliament in the 1970s, showed up at the Institute of Economic Affairs in London, where he met Harris and Seldon, who were kind of the John Lennon and Paul McCartney of British classical liberal economic thinking. Harris and Seldon, in turn, pushed the works of Friedrich Hayek and Milton Friedman. Incidentally, sometime in the mid-1970s, while Thatcher led the Conservative Party, she had a private visit with Hayek at the offices of the Institute of Economic Affairs. After she left, the IEA staff gathered around Hayek to ask his impressions. Not normally at a loss for words, Hayek answered simply, "She's so beautiful."

One of Joseph's most important talks was his 1976 Stockton lecture, "Monetarism is Not Enough."[4] In that talk, later made into a pamphlet, Joseph argued that while monetary policy was the appropriate way to reduce inflation, it was not the appropriate way to deal with the supply-side problems in the economy. For those problems, he argued, the British government needed to reform taxation, regulation, labor policy, etc.

Sir Keith Joseph, by the way, gave a talk at this very meeting in 1980, just over a year after his Conservative Party had taken power. I recall his explaining the difficulty of selling off government enterprises, such as British Steel, that were losing money. He argued that the government needed to turn them into profit-making enterprises before they could be sold. I pointed out that that might mean they would never be sold. David Friedman, if I recall correctly, said something similar. But the best line, which Hannes Gissurarson reminded me of, came from Gordon Tullock, who yelled out, "I'll buy it for a dollar."

In the United States, numerous intellectual developments in the direction of freedom began in the late 1970s and flourished in the 1980s. The most important player was Milton Friedman. Friedman argued that growth in the money supply was responsible for inflation and that there was no permanent tradeoff being inflation and unemployment. Friedman articulated the latter view in a famous lecture as president of the American Economic Association in 1967; Hayek, by the way, had stated that view a few years earlier, arguing that the only way to keep unemployment artificially low was to have higher and higher rates of inflation. Also important in the realm of ideas was Milton and Rose Friedman's *Free to Choose*,[5] based on the 10-part

[3] Daniel Yergin and Joseph Stanislaw, *Commanding Heights*, Simon & Schuster, 1998.
[4] It can be found here: https://www.margaretthatcher.org/document/110796
[5] Milton and Rose Friedman, *Free to Choose*, Harcourt, Brace, Jovanovich, 1980.

PBS series of 1980, which sold hundreds of thousands of copies. In that book, the Friedmans made their case for rolling back government intervention in the economy.

And just as Hayek was important in Margaret Thatcher's intellectual development, so Milton Friedman was important in that of Ronald Reagan. Reagan shared many of Friedman's views and, in his own right, was a public intellectual. During his six years between being governor of California and becoming U.S. president, Reagan delivered hundreds of radio addresses in which he often laid out free-market views.[6]

Many other economists, not just members of the Mont Pelerin Society, contributed to the case for freedom and were also active in actually reducing taxation and regulation.

On taxation, consider the "supply siders." While many mainstream economists dismiss them, their key insight was that an x percent reduction in tax rates leads to less than an x percent, and possibly much less than an x percent, reduction in tax revenues. In the extreme case—and most of the supply-siders were careful most of the time not to be extreme—a reduction in tax rates can lead to an increase in tax revenues. In 1978, Seymour Zucker of *Business Week* wrote:

> To Harvard's Martin Feldstein, the theoretical principle that at some point reducing rates actually increases revenues is something we teach in the first week of Public Finance.[7]

But even though many economists were aware of the insight, they didn't apply it. Most economists in the late 1970s who estimated the effects of cuts in income tax rates assumed that an x percent cut in rates would lead to about an x percent cut in revenues. It took supply siders like Arthur Laffer, Alan Reynolds, Bruce Bartlett, and Paul Craig Roberts[8] to take the supply-side insight and run with it. It was that thinking that helped lead to Ronald Reagan's 1981 tax cut, which dropped the top marginal tax rate from 70 to 50 percent, a drop of 29 percent, and dropped most other marginal tax rates by 23 percent over three years. And although we never did achieve a flat income tax rate, as advocated by Hoover fellows Bob Hall and Alvin Rabushka, their 1985 book, *The Flat Tax*[9], helped get us part of the way there with the 1986 Tax Reform Act, which cut the top income tax rate to 28 percent.

Another major success was in deregulation of airlines, trucking, and telecommunications. In their book, *The Politics of Deregulation*[10], political scientists Martha Derthick and Paul Quirk tell the fascinating story of how that came about in the late 1970s. Because of the scholarly work critical of regulation and because of the publicity much of this work was given, the view that

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[6] Many of them are collected in Kiron K. Skinner, Annelise Anderson, and Martin Anderson, *Reagan, In His Own Hand, Free Press*, 2001.

[7] Seymour Zucker, "Commentary/Economics," *Business Week*, August 7, 1978, pp. 62-64.

[8] Roberts gave a paper on tax policy at the 1980 Mont Pelerin Society meetings at Hoover.

[9] Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Hoover Institution Press, 1985.

[10] Martha Derthick and Paul J. Quirk, *The Politics of Deregulation*, Brookings Institution Press, 1985. For those who want to understand how deregulation came about, I highly recommend this book.

economic freedom in the airline industry was good and regulation was bad became widespread among not only academics but also among policymakers in the Gerald Ford and Jimmy Carter White Houses, in Congress, and even among some regulators. A number of lawyers and economists joined the cause. One important lawyer was Stephen Breyer, now on the Supreme Court, who persuaded Senator Edward Kennedy to make it one of his major issues, as he prepared to run for the Democratic presidential nomination of 1980. Carter-appointed Civil Aeronautics Board (CAB) chairman Alfred Kahn, the most prominent economist involved, worked both on Capitol Hill and in the regulatory agencies to achieve more economic freedom in the industry.

One key figure in deregulating airlines who was less well known was Roy Pulsifer, an assistant director of the CAB's Bureau of Operating Rights. The economics literature persuaded him and he pushed internally for deregulation. Derthick and Quirk write, "When we interviewed him in his office in the CAB in 1980, he had become a radical libertarian, with a picture of the famous free-market economist, Milton Friedman, displayed on his desk."

Interestingly, the airline deregulation story illustrates that the public choice view of regulatory agencies being captured by the industry they regulate is not the whole story. It was precisely staffers and commissioners in the CAB who pushed for deregulation.

The Revolution in Thinking about Socialism

More important than the controversy over taxation and regulation was the big-picture issue: socialism versus the free market. In two important ways, there was a revolution in thinking away from socialism. The first was among economists. Two of the original members of the Mont Pelerin Society, Ludwig von Mises and Friedrich Hayek, had written about the impossibility of using centralized planning to run an economy well. In his 1922 classic, *Socialism*, von Mises wrote:

> Separate accounts for a single branch of one and the same undertaking are possible only when prices for all kinds of goods and services are established in the market and furnish a basis of reckoning. Where there is no market there is no price system, and where there is no price system there can be no economic calculation.[11]

Hayek emphasized the same point, laying it out beautifully and using some concrete illustrations and one nice metaphor, in his 1945 article "The Use of Knowledge in Society[12].

[11] Ludwig von Mises, *Socialism*, Yale University Press, 1951, p, 131. (Translated from *Die Gemeinwirtschaft*, originally published in 1922.)
[12] Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 35, No. 4, September 1945, pp. 519-530. On line at: https://www.econlib.org/library/Essays/hykKnw.html

In 1945, Hayek was a voice crying in the wilderness. But in 1978, in his opening speech at the Mont Pelerin meetings in Hong Kong, Hayek was optimistic. Hayek thought that it was becoming clear that socialism was on the defensive and he called for a grand debate in Paris on socialism versus capitalism. His proposed resolution was “Resolved that coercion is a good way to organize an economy.” In the question period, I said I thought it was a great idea but no socialist would admit that he was advocating coercion and my friendly amendment was that he should come up with a more-neutral word. He said he would consider it.

Two years later, Milton Friedman devoted his whole speech[13] to the Mont Pelerin Society here at Hoover to the issue of socialism and economic calculation. One reason he stated for the issue’s importance was this:

> I believe further that the acceptance of the feasibility of the existence of an autonomous socialist society is an underlying and prior condition to the acceptance of the welfare state, and not the other way around.

Friedman also stated:

> The problem of, and the debate on, economic calculation as it was referred to in the 20s and 30s has turned out to be the best kept secret in the world of economic thought.

The debate that Hayek had proposed in 1978 never happened, but it didn’t need to. It’s true that as late as 1989, Paul Samuelson and William Nordhaus wrote in their textbook *Economics*:

> The Soviet economy is proof that, contrary to what many skeptics had earlier believed, a socialist command economy can function and even thrive.[14]

But something more momentous happened that same year and the next year. One of the America’s most-famous socialist economists admitted that von Mises and Hayek had won the debate. That economist was Robert Heilbroner. In a 1989 article in the *New Yorker*, Heilbroner wrote:

> Less than 75 years after it officially began, the contest between capitalism and socialism is over: capitalism has won…. Capitalism organizes the material affairs of humankind more satisfactorily than socialism.[15]

And in a 1990 article in the socialist publication *Dissent*, Heilbroner gave credit where credit was due, writing:

[13] I found his copy of the address in the Hoover archives.
[14] Paul A. Samuelson and William D. Nordhaus, *Economics*, 13th ed. McGraw-Hill, p. 837.
[15] Robert Heilbroner, “The Triumph of Capitalism,” *New Yorker*, January 23, 1989.

> But what spokesman of the present generation has anticipated the demise of socialism or the "triumph of capitalism"? *Not a single writer in the Marxian tradition!* Are there any in the left centrist group? None I can think of, including myself. As for the center itself—the [Paul] Samuelsons, [Robert] Solows, [Nathan] Glazers, [Seymour Martin] Lipsets, [Daniel] Bells, and so on—I believe that many have expected capitalism to experience serious and mounting, if not fatal, problems and have anticipated some form of socialism to be the organizing force of the twenty-first century.
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> … Here is the part hard to swallow. It has been the Friedmans, Hayeks, von Miseses, *e tutti quanti* who have maintained that capitalism would flourish and that socialism would develop incurable ailments. Mises called socialism "impossible" because it has no means of establishing a rational pricing system; Hayek added additional reasons of a sociological kind ("the worst rise on top"). All three have regarded capitalism as the "natural" system of free men; all have maintained that left to its own devices capitalism would achieve material growth more successfully than any other system.[16] (italics in original)

Game, set, and match to von Mises, Hayek, and Friedman.

Incidentally, in the first edition of my encyclopedia, *The Fortune Encyclopedia of Economics*, I had Heilbroner write the entry on socialism. In the first draft he sent me, he wrote that one of the reasons he and others felt right about dismissing Mises and Hayek's criticisms in the 1940s was that they were nasty people. As an editor, I typed a query: please explain this claim. When the next draft came back, the explanation was lacking but, interestingly, so was the claim.

The other important revolution in thinking about socialism was among Asian politicians. In Asia in the late 1970s and 1980s, some important government officials dropped their belief in socialism simply by paying attention to physical reality.

The most important player was Deng Xiaoping. In 1978, as mentioned earlier, Chinese peasants, faced a severe drought. They were unwilling to break through the hard land for the sake of a collective owner, and pleaded with communist leader Deng Xiaoping to allow each family to keep all production, in excess of a low quota, on the land they tilled. Deng allowed it, creating a de facto system of property rights and an implicit marginal tax rate of zero. The result: between 1978 and 1990, the share of agricultural output sold in open markets rose from 8 percent to 80 percent and in the six years after 1978, real income in farm households rose by 60 percent. Deng also allowed more freedom to companies located in Special Economic Zones

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[16] Robert Heilbroner, "The World After Communism," *Dissent*, Fall 1990, pp. 429-430. Quoted in Robert Heilbroner, "Socialism," in David R. Henderson, ed., *The Concise Encyclopedia of Economics*, Liberty Fund, 2008. At: https://www.econlib.org/library/Enc/Socialism.html

along China's coast, which then grew much faster than the rest of China. "I have two choices," said Deng. "I can distribute poverty or I can distribute wealth." He chose the latter.

Another convert was the head of the propaganda department of the Chinese Communist Party. After visiting Japan in the mid-1980s, he wrote a report on his visit. He noted that half of Japanese households owned a car and that over 95 percent of households owned TV sets, refrigerators, and washing machines. What also hit him over the head was the variety of clothing people wore: "One Sunday we went out to a busy street. Of all the women we saw, no two wore the same style of clothes." Then he added, "The female workers accompanying us also changed clothes every day."[17]

Or consider Manmohan Singh, an Indian socialist who had served as secretary of the South Commission, a commission peopled by believers in state intervention. Singh earned his undergraduate economics degree at Cambridge and his Ph.D. at Oxford[18] and made his living as a central planner. But in 1987, Mr. Singh took a little trip—to East Asia. This one trip led to an ever bigger intellectual journey. As Yergin and Stanislaw write, "He was stunned." Singh knew that as recently as 1960, India's per capita income rivaled South Korea's. But in just one generation, South Korea's per capita income had reached 10 times that of India. He noted two main factors behind this difference. First, whereas East Asian governments supported business, India's government heavily regulated them. Second, the East Asian countries had benefited from trade, in contrast to India's almost sealing off the border to trade.[19] Clearly, this is an example of a person who was convinced by seeing the results of (relative) freedom.

Singh went on to become finance minister under Prime Minister Rao and, together, with commerce minister P. Chidambaram, began to open the economy to trade and foreign investment and dismantle the "Permit Raj," India's system of heavy regulation. Within weeks, Rao's government cut subsidies for domestic products and for exports, reduced tariffs and trade barriers, eliminated licenses for 80 percent of industry, eliminated the requirement that large firms get permission to expand or diversify, and opened the economy to foreign investment. Invoking Mahatma Gandhi's vision of self-reliance, Singh stated, "Self-reliance means trade and not aid."[20]

Individuals and Ideas Matter

One common interpretation of history is that whatever happens is inevitable; that because great historic forces are at work, particular ideas and individuals don't matter for the outcome. This Marxist-like view is one that, interestingly, George Stigler embraced. In fact, his statement

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[17] *Commanding Heights*, p. 200, quoting from Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk: M.E. Sharp, Inc., 1994), p. 37.
[18] *Commanding Heights*, pp. 220-221.
[19] *Commanding Heights*, p. 222.
[20] *Commanding Heights*, p. 225.

of that viewpoint was the main part of his 1978 presidential address to the Mont Pelerin Society in Hong Kong.

In that speech, Stigler argued that Mont Pelerin members who thought their ideas could change the world were mistaken because, he asserted, policymakers were already making judgments rationally and in their own self-interest. So, for example, there was no point in explaining to politicians that their tariffs on steel hurt consumers more than they helped the domestic steel industry. The policymakers already knew that and wanted to help producers at the expense of consumers. Therefore, there was nothing important that a believer in freedom could tell a politician.

After his Hong Kong speech, I asked Stigler if one could summarize his message with the statement that you can't tell people they are making mistakes because they already know everything they need to know. He said yes. Then why, I asked, did he bother giving the speech? Wasn't his goal to persuade the potential activists at the Mont Pelerin Society of something they didn't already believe?

What Stigler overlooked is that politicians, like the rest of us, have imperfect information. That he failed to note the import of this simple fact is shocking given his important role in getting economists to start thinking seriously about the economics of information. It's also shocking given his role in systematizing the economic analysis of regulation.

Politicians, like everyone else, have imperfect information about the world and, specifically, about the effects of various government policies. That's just a simple fact. Further, the kind of information they receive about the effects of government policies will be systematically biased in a particular direction.

As Stigler and others before him (Anthony Downs and Gordon Tullock, to name two) had pointed out, government policies tend to impose small per-capita costs on a large number of people in order to generate large per-capita benefits for a much smaller number of people. The beneficiaries from government policy, because they each benefit so much, will have a **loud** voice in emphasizing the benefits of the policies they favor. The losers from government policy, because each loses only a little, will have a very quiet voice in emphasizing the losses from government policy. So, for example, when the issue of import quotas on sugar is debated in Congress, the advocates of sugar quotas—who each gain thousands (and in a few cases, millions) of dollars annually from the quotas—will be very active in the debate, pointing out to wavering congressmen the gains in jobs created in the domestic sugar industry. The 300 million consumers of sugar, though, who lose an average of between $6 and $10 a year, will not even know about the debate. A politician who simply pays attention to what he hears, therefore, will tend to favor restricting imports, even though it can be shown that the cost to consumers exceeds the gains to domestic producers.

In his book, *The Culture of Spending*[21], James L. Payne reports that of a total of 1,060 people who testified before 14 House and Senate committees in selected years in the mid-1980s, 1,014 of them, or 95.7 percent, were in favor of the government programs. There were only seven opponents, or 0.7 percent of the overall number of witnesses. In other words, proponents outnumbered opponents 145 to 1.

Because politicians hear mainly from the beneficiaries of government policies, many of them can easily believe that most government policies produce net gains for society. You need to live in Washington or Ottawa or any capital city for only a short time to see how insulated politicians usually are from information about the negative consequences of their policies. Adding to that insulation is the fact that one important group of beneficiaries is the government bureaucracy. Payne found that of the 1,060 congressional witnesses mentioned above, 673 were government officials (497 of them being federal administrators), including 65 members of Congress. In other words, 63.5 percent of those testifying were government officials.

The combination of imperfect and biased information causes many politicians not to know—and possibly not even to suspect—that their policies cause widespread harm. Thus, what looks like a stable political equilibrium may in fact be an unstable equilibrium that could change with enough politicians acting on good information. Indeed, there are probably knife-edge equilibria that could be upset if just a few influential politicians change their ideas.

An observer and participant who knows far more than I of efforts to implement economic freedom in Latin America is UCLA's Arnold Harberger. He was one of the main economics professors at the University of Chicago who taught the "Chicago boys," the economists from Chile and other Latin American countries who returned home in the 1970s and 1980s and implemented various pro-freedom reforms.

In 1993, Harberger wrote of:

> [M]y long-standing conviction that successful economic policy in developing countries is very far from being the product of pure forces of history—something that happens when it happens because its time has come. Far from it, in every case about which I have close knowledge, the policy would in all probability have failed (or never got started) but for the efforts of a key group of individuals, and within that group, one or two outstanding leaders.[22]

In short, ideas matter and the individuals who hold them matter.

[21] James L. Payne, *The Culture of Spending*, ICS Press, 1991.

[22] Harberger, "Secrets of Success: A Handful of Heroes," *American Economic Review*, May 1993, Vol. 83, No. 2, pp. 343-350

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Henderson has also appeared on *The NewsHour with Jim Lehrer*, *The John Stossel Show*, *The O'Reilly Factor*, and networks including C-SPAN, CNN, MSNBC, RT, NPR, CBC, and BBC. Born and raised in Canada, he moved to the United States in 1972 to earn his PhD in economics at UCLA. He became a US citizen in April 1986.

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