Economic Insights

FEDERAL RESERVE BANK OF DALLAS VOLUME 7, NUMBER 2

# Milton Friedman

## Economist as Public Intellectual

*If asked to name a famous economist, most Americans would probably say Milton Friedman. Economists usually make their contributions behind the scenes at think tanks, government agencies or universities. Friedman has done that, but he also has taken his ideas and policy proposals directly to his fellow citizens through books, magazine columns and, especially, television.*

*It is not an exaggeration to say he has been the most influential American economist of the past century. He has changed policy not only here at home but also in many other nations, as much of the world has moved away from economic controls and toward economic freedom.*

*Milton Friedman marks his 90th birthday on July 31, 2002, and the Dallas Fed commemorates the occasion with this issue of* Economic Insights. *Happy birthday, Milton!*

**—Bob McTeer**
President, Federal Reserve Bank of Dallas

Professor Steven N.S. Cheung

*Milton Friedman*

Milton Friedman has been an ardent and effective advocate for free enterprise and monetarist policies for five decades. He was born in Brooklyn, N.Y., in 1912, the son of Jewish immigrants who had come to America in the late 1890s. He attended public schools, then entered Rutgers University in 1928. Being away from home for the first time gave Friedman important early work experiences, as well as insights into entrepreneurship and the business processes of the market economy (Friedman and Friedman 1998, 25–27).

Originally a math major, Friedman switched to economics in his third year at Rutgers, a decision that brought him into the classrooms of two men who would guide his later life: Homer Jones and, especially, Arthur F. Burns. Burns later became a fixture at the National Bureau of Economic Research (NBER), one of the nation's foremost authorities on business cycles and, ultimately, chairman of the Federal Reserve Board of Governors (1970–78). Burns led Friedman to begin an appreciation of what good scholarship entailed and introduced the young economist to the works of Cambridge School of Economics founder Alfred Marshall. Jones, a pivotal figure in the monetarist camp, introduced Friedman to Frank Knight and the early Chicago school, especially Knight's *Risk, Uncertainty, and Profit*.

After Friedman received his undergraduate degree from Rutgers, Jones arranged a scholarship for him to study economics at the University of Chicago, where Friedman received an M.A. in 1933. During that year in Chicago, he also met his future wife, fellow economics student Rose Director, who became an active partner in his professional work. He continued his graduate study at Columbia University and completed his Ph.D there in 1946.

While at Columbia, Friedman met and was influenced by other famous economists, including John Maurice Clark, Harold Hotelling and NBER founder Wesley Clair Mitchell. Friedman was soon working at the NBER as an assistant to Simon Kuznets, famous for developing the national income product accounts and many of the techniques applied to them in the 1920s and '30s. Because Friedman's early study in economics involved constant contact with theorists such as Burns, Mitchell and Kuznets, it is not surprising that he became more focused on macroeconomic issues like monetary theory and business cycles than on the microeconomics of Burns' own favorite, Marshall.[1]

Unable to secure a university appointment because of anti-Semitism and a dearth of openings, Friedman began his career in 1935 in Washington, D.C., during the early days of the New Deal. At the National Resources Committee, he used his statistical acumen to help develop better consumer spending studies so that improved historical data and better price indexes could be developed. Friedman's knowledge of sampling theory was especially relevant in this undertaking, and his first journal articles resulted from these early efforts.

In the late 1930s, Friedman began collecting and analyzing data on the distribution and size of income, which later figured prominently in what he considers his best work, *A Theory of the Consumption Function.* In this 1957 book, he for the first time put forth his famous permanent income hypothesis. This explanation for consumption behavior offered an alternative to the theory propounded in John Maynard Keynes' *The General Theory of Employment, Interest, and Money.* Friedman's work showed Keynes' stable, predictable consumption function is an empirically inaccurate estimator of short-run, aggregate consumption. Friedman offered his alternative permanent income function, along with a theoretical discussion that plausibly explained why his theory was better. In producing this work, Friedman put into practice a methodology that became the foundation of one of the most cited and attacked—and defended—articles in the history of economics: *On the Methodology of Positive Economics* (1953, 1–43).

The most controversial contention in this essay is that a theory's assumptions don't matter because predictive power is everything. The essay also asserts that a simpler theory is preferable if it predicts a higher number of outcomes—a variation on Occam's Razor—and that a good theory will "surprise" us by predicting counterintuitive outcomes. A good theory is one that "explains a lot by little" and has been subjected to many attempts at empirical "falsification," a philosophical stance that Friedman apparently absorbed from Karl Popper.[2] To his credit, and regardless of the correctness of his views on scientific method, Friedman's own empirical work conforms to his view of the proper way to "do science."

Friedman contributed to another important effort while in Washington during World War II. At the Treasury Department, he helped create the current federal income tax withholding system. Friedman says he now regrets his role, although at the time he believed the new system was superior to the one it replaced (Friedman and Friedman 1998, 123). Working in Washington gave him great insight and the chance for a firsthand look at how bureaucracies function.

Hoover Institution

*Rose and Milton Friedman in 1987.*

The war brought many changes. For the Friedman family it meant a move to New York City, where Milton joined the Statistical Research Group at Columbia University in 1943. This group worked on a number of war-related issues, from proximity fuses in bombs to the vulnerability of bombers during their runs. Statisticians' role in the war has generally been overlooked, but their contributions were important, especially as they developed the techniques still used today in modern econometric analysis.

After the war, Friedman spent a year teaching at the University of Minnesota, then took a job at the University of Chicago in 1947 and stayed there until his retirement from teaching in 1977. While at Chicago, he became the leader of the first recognized counterrevolution against Keynesianism. Keynes' view poses that government could, and should, fine-tune the nation's macroeconomic performance, simultaneously guaranteeing an end to the business cycle and perpetual full employment.

Friedman, a classical liberal who believes in free markets, opposed this view and the theoretical mechanisms that justified it. He developed the economic paradigm that the University of Rochester's Karl Brunner named *monetarism.* Friedman himself disapproves of this "unlovely" term (Friedman and Friedman 1998, 228). Nonetheless, his resurrection of the classical school's foundation for its monetary theory—

## Historical Myths in American Economic Development

While the nineteenth century was a period of rugged individualism, almost every other feature of the myth [of the robber barons] is false. Far from being a period in which the poor were being ground under the heels of the rich and exploited unmercifully, there is probably no other period in history, in this or any other country, in which the ordinary man had as large an increase in his standard of living as in the period between the Civil War and the First World War, when unrestrained individualism was most rugged. The evidence of this is to be found in the statistics that economists have constructed of what was happening to national income, but it is documented in a much more dramatic way by the numbers of people who came to the United States during that period. That was a time when we had completely unrestricted immigration, when anybody could come to these shores and the motto on the Statue of Liberty had some real meaning. This was a country of hope and of promise for immigrants and their children….Did people come to this country to be ground under the heels of merciless capitalists? Did they come to make their own conditions worse?

There is no more dramatic way in which people can vote than with their feet. The fact that East Germany had to build a wall to keep people from going to West Germany is striking evidence of which country had the better conditions of life. In the same way, the fact that year after year hundreds of thousands of people left the countries of Europe to come to this country was persuasive evidence that they were coming to improve their lot, not to worsen it. Far more effective evidence, I believe, than any statistics on per capita real income, which show that real income went up decade after decade at a rate of 2, 2.5, 3 percent per year. They came with empty hands....It was the poor and the miserable who flocked here, and they found a home and the opportunity to improve their lot. And they found it, not despite rugged individualism but because of rugged individualism. It was rugged individualism that induced the developments in industry, in trade, that offered opportunities to people. ■

—*Bright Promises, Dismal Performance: An Economist's Protest*, 62–63

## A Monetarist Looks at Inflation

The recognition that *substantial inflation is always and everywhere a monetary phenomenon* is only the beginning of an understanding of the cause and cure of inflation. The more basic questions are: Why do governments increase the quantity of money too rapidly? Why do they produce inflation when they understand its potential for harm?

Before turning to those questions, it is worth dwelling a while on the proposition that inflation is a monetary phenomenon. Despite the importance of that proposition, despite the extensive historical evidence to support it, it is still widely denied—in large part because of the smoke screen with which governments try to conceal their own responsibility for inflation.

If the quantity of goods and services available for purchase—output, for short—were to increase as rapidly as the quantity of money, prices would tend to be stable. Prices might even fall gradually as higher incomes led people to want to hold a larger fraction of their wealth in the form of money. Inflation occurs when the quantity of money rises appreciably more rapidly than output, and the more rapid the rise in the quantity of money per unit of output, the greater the rate of inflation. There is probably no other proposition in economics that is as well established as this one. ■

—*Money Mischief: Episodes in Monetary History*, 193

the quantity theory—led to the establishment of a demand-side alternative to Keynes for conducting macroeconomic policy. Given Friedman's position at Chicago, the prestige of its economics department and the ability of his students, it is hardly surprising that monetarism caught on across the nation and became highly influential during the 1960s and '70s. Monetarism stresses the importance of the quantity of money as an instrument of government policy and as a determinant of business cycles and inflation.

What accounted for this shift in thinking by economists, bankers and politicians who had so fervently argued for Keynesianism for two decades? A series of articles and books and one speech did the trick. The books were *Studies in the Quantity Theory of Money* (1956) and *A Monetary History of the United States* (1963). The speech was the presidential address to the American Economic Association in 1967. Its thesis was that the so-called trade-off between inflation and unemployment, known as the Phillips curve, was not a sustainable, long-run policy option. In the speech, Friedman resurrected the classical notion of real factors determining long-run employment, with monetary changes unable to lower the unemployment rate in the long run. Considered heresy at the time, the natural rate hypothesis—as it has come to be known—is now taught, alongside his permanent income hypothesis, as standard macroeconomic theory.

In 1962, Friedman published a book based on a series of lectures he gave at seminars sponsored by the Volker Foundation. That book—*Capitalism and Freedom*, cowritten with his wife, Rose—subsequently sold half a million copies in 18 languages and launched Friedman's career as one of America's policy intellectuals. His name is known to more Americans than that of any other economist. Contributing to his visibility were his triweekly column in *Newsweek* magazine (1966–84) and his 10-part PBS program *Free to Choose* (1980), which complemented a book of the same name cowritten with Rose.

During this period, he also was an adviser to three presidential candidates: Barry Goldwater (unofficially), Richard Nixon and Ronald Reagan. Many policy ideas that emerged from this period bear his stamp: the all-volunteer military, the negative income tax, floating money-exchange rates, the Dutch auction procedure for selling government securities, school vouchers and opposition to wage–price controls. The list is long and impressive, both in its scope and in the original thinking applied to several of these issues. The 1976 Nobel Memorial Prize in Economic Sciences cemented in the public's mind his position as one of the world's leading economists. Ironically, Friedman dislikes this publicity aspect of the Nobel Prize (Friedman and Friedman 1998, 443).

After leaving Chicago in 1977, Friedman became a senior fellow at

## Does Business Have a "Social Responsibility?"

The view has been gaining widespread acceptance that corporate officials and labor leaders have a "social responsibility" that goes beyond serving the interest of their stockholders or their members. This view shows a fundamental misconception of the character and nature of a free economy. In such an economy, there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud....It is the responsibility of the rest of us to establish a framework of law such that an individual in pursuing his own interest is, to quote Adam Smith again, "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."

Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine. If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest? Is it tolerable that these public functions of taxation, expenditure, and control be exercised by the people who happen at the moment to be in charge of particular enterprises, chosen for those posts by strictly private groups? If businessmen are civil servants rather than the employees of their stockholders then in a democracy they will, sooner or later, be chosen by the public techniques of election and appointment. ■

—*Capitalism and Freedom*, 133–34

## Who Pays for Foreign Export Subsidies?

Another source of "unfair competition" is said to be subsidies by foreign governments to their producers that enable them to sell in the United States below cost. Suppose a foreign government gives such subsidies, as no doubt some do. Who is hurt and who benefits? To pay for the subsidies the foreign government must tax its citizens. They are the ones who pay for the subsidies. U.S. consumers benefit. They get cheap TV sets or automobiles or whatever it is that is subsidized. Should we complain about such a program of reverse foreign aid? Was it noble of the United States to send goods and services as gifts to other countries in the form of Marshall Plan aid or, later, foreign aid, but ignoble for foreign countries to send us gifts in the indirect form of goods and services sold to us below cost? The citizens of the foreign government might well complain. They must suffer a lower standard of living for the benefit of American consumers and some of their fellow citizens who own or work in the industries that are subsidized. No doubt, if such subsidies are introduced suddenly or erratically, that will adversely affect owners and workers in U.S. industries producing the same products. However, that is one of the ordinary risks of doing business. Enterprises never complain about unusual or accidental events that confer windfall gains. The free enterprise system is a *profit* and *loss* system. As already noted, any measures to ease the adjustment to sudden changes should be applied evenhandedly to domestic and foreign trade. ■

—*Free to Choose: A Personal Statement*, 45

Stanford's Hoover Institution and moved to San Francisco. Even in retirement, Friedman continues to travel, lecture and write, still in the fray of contested ideas, still expressing his views on current economic and political issues. He will be remembered, of course, for his technical brilliance as an economist. However, like the 19th-century French economist–journalist Frédéric Bastiat, Friedman's ability to engagingly and directly communicate economic theory to average people may well be his greatest legacy.

On May 9, 2002, Friedman was honored for lifetime achievements by President George W. Bush, who said during the ceremony, "He has used a brilliant mind to advance a moral vision—the vision of a society where men and women are free, free to choose, but where government is not as free to override their decisions. That vision has changed America, and it is changing the world."

Federal Reserve Chairman Alan Greenspan, who attended the ceremony, added, "There are many Nobel Prize winners in economics, but few have achieved the mythical status of Milton Friedman." ■

**— Robert L. Formaini**
Senior Economist

## Notes

1 He did not ignore Marshall and microeconomics, however. He has written or coauthored many articles on choice under uncertainty and has examined Marshall's demand function in great detail. See Friedman (1949). Some economists argue that Friedman's great success in changing minds on macro issues flows from his mastery of microeconomics. See Walters (1987, 426).

2 Popper (1968). Two points: Popper was inconsistent in his belief in the inductive problem or its possible solution, and falsification can only work if a theory is formulated in such a way that it can be falsified by empirical evidence.

## Sources and Suggested Reading

Frazer, William, and Lawrence Boland (1983), "An Essay on the Foundation of Friedman's Methodology," *American Economic Review* 73 (March): 129–44.

Friedman, Milton (1949), "The Marshallian Demand Curve," *Journal of Political Economy* 57 (December): 463–95.

——— (1953), "On the Methodology of Positive Economics," in *Essays in Positive Economics* (Chicago: University of Chicago Press), 1–43.

——— (1957), *A Theory of the Consumption Function* (Princeton, N.J.: Princeton University Press).

——— (1981), *Milton Friedman's Monetary Framework: A Debate With His Critics* (Chicago: University of Chicago Press).

——— (1982), *Capitalism and Freedom* (Chicago: University of Chicago Press), orig. pub. 1962.

——— (1983), *Bright Promises, Dismal Performance: An Economist's Protest* (San Diego: Harcourt Brace Jovanovich).

——— (1992), *Money Mischief: Episodes in Monetary History* (New York: Harcourt Brace Jovanovich).

——— (1993), *Why Government Is the Problem* (Palo Alto, Calif.: Hoover Institution).

Friedman, Milton, and Rose Friedman (1980), *Free To Choose: A Personal Statement* (New York: Harcourt Brace Jovanovich).

——— (1998), *Two Lucky People: Memoirs* (Chicago: University of Chicago Press).

Friedman, Milton, and Anna Schwartz (1963), *A Monetary History of the United States*, 1867–1960 (Princeton, N.J.: Princeton University Press).

Hirsch, Abraham, and Neil De Marchi (1990), *Milton Friedman: Economics in Theory and Practice* (New York: Simon and Schuster International).

Popper, Karl (1968), *The Logic of Scientific Discovery* (New York: Harper Torchbooks).

Walters, Alan (1987), "Milton Friedman," in *The New Palgrave: A Dictionary of Economics*, vol. 2, ed. John Eatwell, Murray Milgate and Peter Newman (New York: Stockton Press).

***Economic Insights*** is a publication of the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve System.

**Please address all correspondence to**
*Economic Insights*
Public Affairs Department
Federal Reserve Bank of Dallas
P.O. Box 655906
Dallas, TX 75265-5906

Visit our web site at www.dallasfed.org.