

Adam Smith in the 20th Century

by Allan H. Meltzer

I am greatly honored to be the 1999 recipient of the Adam Smith Award. It is a privilege to stand here where my illustrious predecessors have stood. Like many others in my generation, I started on the left. As a college student, I believed then that both intellectual superiority and historical evolution were on that side.

I cannot say that three great teachers---Armen Alchian, William Allen and Karl Brunner--turned me around by 180 degrees. I had already made about a 90-degree turn by the time I met them in graduate school. They began the process by which the full change occurred, not by persuasion or argumentation or, as far as I know, conscious effort. What influenced me was their ability to teach the logic of modern economic theory and use it to explain large parts of what we observe. I am, therefore, a beneficiary of the type of activity that your association sponsors.

Those who have gathered here are especially qualified to recognize the powerful logic and contemporary relevance of the ideas about free markets and free enterprise first put forward systematically by Adam Smith. The power of those ideas is exemplified by three facts.

First, the ideas have endured through two and one quarter turbulent centuries, in itself a remarkable achievement. Few books have remained in print as long.

Second, the acceptance of markets, personal incentives and freedom of enterprise is now more widespread than at any time in the past. More of the world's population, including many people who have neither read nor read about *The Wealth of Nations* appreciate the importance of private ownership, personal incentives, and market mechanisms as the source of growth and wealth creation.

Third, following the spread of these ideas, and as a direct result of their dissemination, more people in more countries have experienced increases in living standards than in any comparable period of human history. One of your members, Michael Cox, has documented these successes in some outstanding articles in the recent annual reports of the Federal Reserve Bank of Dallas. These papers, and the experience in many countries, show the power of the

ideas of Adam Smith in practice. And Professor Robert Fogel has documented how the power of the market to generate wealth, creativity, and innovation has provided both the resources and the technology to dramatically raise levels of health, education and longevity. These achievements are not just dismissed, they are completely overlooked by those who prattle on about the lack of morality under capitalism or its lack of concern for individuals and their well-being.

Now, even the most skeptical should be able to see that market freedom and political freedom are complements. Perhaps the outstanding accomplishments due to Adam Smith's ideas about markets and freedom in the late twentieth century is the defeat of communism. This defeat is, I believe, the direct consequence of three occurrences.

First was the rising difference in standards of living in countries ruled by Communists compared to democratic capitalist countries. People who lost their personal and political freedom paid an enormous price in material goods and services as well. They were not only relatively poorer, but the difference increased over time. Far from burying us, as Nikita Khrushchev had threatened, it was they who were being left behind.

The difference in costs was not just material. Political freedom was greater in the market economies. People had the right to choose their leaders and to dismiss them if they became arrogant, oppressive, or made mistakes. Left-leaning intellectuals often dismiss voting as inconsequential because it does not bring about the changes they favor. For me, this is a virtue, but it is not its only virtue. The right to dismiss political leaders protects us from despots, tyrants, and other authoritarians as voters in the former Communist countries, in Latin America, and Mrs. Gandhi's India probably understood very well.

Political and economic freedom do not just coexist. They are symbiotic in the sense that one cannot be sustained for long, in practice, without the other. Bribery, coercion, and cronyism occur in all societies. We have learned in this century that these practices are most extensive where political and economic freedoms are less extensive. The less extensive role of corruption is one example of the comparatively better moral outcomes under democratic capitalism. These outcomes are better because it is less costly to punish corrupt individuals, those who pollute the environment, or engage in other immoral or anti-social behavior.

Those who believe that our own system of governance is corrupted by our system of campaign finance should reflect on the following proposition. If elected officials had less

arbitrary power to enrich their supporters, they would not get as many or as large contributions from those sources.

Intellectual recognition of these differences in economic organization came slowly, at least for me. I can still recall serious discussions about the alleged wastes of competition under capitalism and the superior performance that could be achieved by government planning and direction of investment and economic activity under collective ownership. Socialism or communism was said to avoid these wastes by intelligent planning.

Marxists forcefully presented these views but, in this century, so did non-Marxists like John Maynard Keynes. Keynes tried to provide a non-Marxist intellectual foundation for government direction of investment. In Keynes's analysis, government could moderate business cycles and unemployment by carefully timing investment spending to take up the slack. His intellectual followers found in his proposal the intellectual case for government activism to redistribute consumption and income from politically less favored to politically more favored groups. In practice, the favored groups were generally those who had a larger share of voting power than of wealth or income.

It is only with hindsight that people everywhere recognized the very high costs of both socialism and Keynesian policies. It has taken many years to accumulate evidence showing that freedom provides a powerful stimulus for change or innovation in new products, services, and productive processes.

This is not to claim myopia. Let me suggest some reasons why it has been difficult to agree on the effects of free choice and free markets on living standards in this century. First, private property and the market system take time to show their superiority. It takes time for small differences in growth rates to show up as large differences in living standards. Often the cumulative effect becomes large only after a decade or more. It was only in the 1980s that the balance of so-called informed opinion shifted from the belief that the Soviet Union would overtake the market economies.

Recent publication of *The Haunted Wood*, telling the stories of Americans and some Europeans who spied for the Soviet Union in the 1930s and 1940s, reminds us that most of these people became spies out of conviction. Most did not take money. They claimed that they were working to make the world a better place. Klaus Fuchs and others who gave away vital information about the atomic bomb professed that the world would be safer and better if the

Soviet Union, not the United States, had atomic weapons. They could not prevent the United States from developing the atomic bomb, but they could, and did, work to cancel the military advantages by spying for the USSR.

Ideas and beliefs, even bad ideas if widely shared, shape the political and social consensus and, thus, the environment in which political and economic decisions are made. On average, those who lived through the great depression hold a different view about the role of government than those who experienced only postwar prosperity. It is important to recall that it was only in the 1960s that Milton Friedman and Anna Schwartz published their studies showing that the great depression was the result of government failure, not private market failure. And it took many years for that view to become the established, professional view. Even now every large decline in values on the New York Stock Exchange, and other leading exchanges, is followed by speculation that another "crisis of capitalism" is at hand. And this despite the overpowering evidence showing that the 1929 stock market crash did not cause the subsequent depression.

Further, growth in output can be achieved by forcing investment and copying technologies. Russia in the 1930s, Poland in the 1960s, and perhaps China achieved moderate to high growth rates by forcing saving to get high rates of investment. We now know that much of the investment in Russia and Poland was inefficient. Dams, steel mills, and shipyards created jobs and income when the capital was invested and infrastructure was built. The investment was inefficient because there were no market prices directing investment toward efficient uses and few incentives for managers or workers to care about quality of product or efficient use of resources.

Asian countries adopted best practice by importing capital and educating their citizens to use new technologies. For a long time, it was difficult to distinguish performance in countries like Taiwan and Hong Kong, that relied much more on markets and private incentives, from countries like Indonesia and Korea, where government used industrial policy to direct investment and development. It is clearer now that the more market oriented systems avoided heavy investment in industries like steel, automobiles and semi-conductors with large excess capacity.

It is not always true that the market system makes correct choices and the state makes mistakes. Often it has taken decades for differences to appear clearly. In the 1960s, President Kennedy was attracted to French "indicative planning" by the state. South Korea adopted a

variant. Until about a decade ago, Japan's mix of private and public planning held great appeal. High savings rates, personal incentives, education and training, and some correct government decisions made these processes seem highly successful. It is only recently that we and they have recognized that the gains came early while the losses, and waste of resources were hidden in the banking system's bad loans and their counterpart, the capital investments that must be written off or sold at prices far below book value.

In this century, Friedrich Hayek supplemented Adam Smith's message. One of Hayek's important additions was to highlight the roles of uncertainty and experience. Often we learn slowly, from experience, what works and what fails, what is better and what is worse.

Modern China illustrates the slow process by which the content of received wisdom changes. For the first quarter century of communist rule, the government prohibited free choice and free market processes. Tight political control made opposition costly. It was only after a generation that the leadership recognized that, in taking their ideas from Marx and Lenin, they had been reading and repeating maxims from the wrong books. The powerful examples all around them helped them to recognize both the need for change and the direction of change.

China has moved toward more reliance on market processes. It did not become a free society or a free market economy. The Chinese are still far away from the freedoms enjoyed in Japan, Korea and many other Asian or European countries, still further from the United States or Hong Kong. And all of these countries or regions are far from the free societies described by Adam Smith in the *Wealth of Nations* or Milton Friedman in *Capitalism and Freedom*.

I will offer three reasons why no country in the 20th century has attempted to limit the role of government to the provision of a small number of public goods like defense or the rule of law.

First is the concentration of political power. Where political freedom is greatly restricted, decision power is limited. Where voters cannot dismiss their political leaders, they can complain only to the extent that is permitted. Terror is a weapon, but so is uncertainty. Lenin, Stalin, and Hitler used terror to limit protest. But they also relied on uncertainty about the rules, about what was permitted and what was punishable, to reduce protest. If both offenses and penalties are highly uncertain, self-restraint is a rational response. Never knowing what is permitted encourages behavior intended to prevent personal harm. Mao, Stalin, Lenin and Hitler were

willing to use terror and the threat of terror to prevent protest. Even suspicion of being in opposition was punished by imprisonment or execution.

Gorbachev and his satraps in Eastern Europe were less willing to use maximum force. Their regimes ended as soon as it became clear that they would not use their power. Citizens as voters were able to claim rights that had been denied. They chose more political freedom and more economic freedom. But nowhere did they choose a minimal state.

Ideology is a second means of control. Appeal to common beliefs such as religion or communism reduces or limits opposition. Iran after the overthrow of the Shah is a familiar example of the use of common belief to supplement and even substitute for force as a means of achieving agreement on social rules and norms. I do not know of a theocratic state that ever chose limited government to the principles set out by Adam Smith or Milton Friedman.

For sixty or seventy years, long before Keynes's ideas became popular, Sweden combined political freedom and social freedom with relatively high tax rates, restrictions on property rights and economic freedom. Politicians that adopt and retain these measures are re-elected. Politicians that set out to reduce regulation and the welfare state meet resistance from voters and lose elections. I do not think we can explain these outcomes without accepting that the Swedish welfare state rests on the consent of a majority of the governed. There is sufficient common ideology or belief to maintain the welfare state.

Much the same can be said about voters or citizens in most of western Europe. Although the size of these welfare states has increased substantially since World War II, voters have chosen to keep the welfare state and extend it. There were even demonstrations in Germany when the Kohl government tried to change an entitlement that granted four weeks in a spa every three years to three weeks every four years. Too much sacrifice!

Voting is the third means by which citizens in all democratic countries have approved expansion of the redistributive and administrative state. Voting rights are distributed equally, each adult has one vote. Wealth and income are distributed unequally. The average voter has less than the average income. Unless property rights are protected, universal voting is a license to redistribute. Impediments to redistribution such as provisions of the U.S. or Swiss constitutions that weaken majority rule limit redistribution but have not prevented it.

A vote for redistribution is a vote to increase consumption spending today even if it reduces saving, investment and future income. Those who succeed in the market place typically

vote against such schemes. Those who do not succeed go to the polling place to increase their consumption by redistributing income.

This third explanation of the growth of government explains why we do not see the liberal societies with limited government that Smith proposed even where such choice is feasible. Government has grown in size and power in all democratic countries. Voters rarely repeal or rescind programs that redistribute income. Traditional liberal political parties have almost disappeared in the last half of this century.

To understand whether governments will continue to gain power, we have to understand the forces that have fostered redistributive policies, government regulation and high tax rates in this century. War and defense have been important causes. War martial resources under government control. Governments may draft men (and women), control the use of materials, raise tax rates to very high levels, and in other ways accumulate power. Power shifts from individuals, markets, or local and regional government to the nation state. If we continue to experience military threats, the nation state will remain large and powerful. Let us put war aside.

Two forces work in the opposite direction. One is differences in economic growth; the second is new technologies. New technologies contribute to growth, so the two are related. That said, I will treat them separately because they raise separate issues.

For many years, countries like Sweden, Germany, or France could claim that large scale redistribution and high tax rates did not reduce the growth rate of income relative to growth in the United States. Many of these countries gradually closed much of the difference in per capita income with the United States that persisted through the 20th century.

It is no longer true. Since 1991, U.S. real income (GDP) has increased much faster than European incomes---about 15% faster from 1991 to 1998. The difference is not explained entirely by differences in productivity growth, at least not by manufacturing productivity, the only part of productivity growth that is measured at all reliably. Employment growth, particularly growth of non-subsidized employment, explains a large part of the difference.

To pay for the welfare state, many European governments impose high taxes on the use of labor and high tax rates on labor income. These taxes discourage hiring and effort. Generous long-term benefits to the unemployed discourage work in the taxable part of the economy. A European worker not only pays for the benefits he or she receives but must pay to support the

unemployed and their families. The unemployed, often 10% of the labor force or more, produce nothing officially, although they may be active in the under-ground economy.

The gap in income between the U.S. and the European Union has widened as the decade went on. There is as yet no sign of an end or reversal.

The second force is the difference in the spread of new technology in Europe and the United States. It is hardly noticed that, in the U.S., technology has spread rapidly in the industries that were deregulated in the 1970s and 1980s---principally, financial services, transportation and telecommunications. These, recently deregulated sectors, account for a large and rising share of investment and output. And their growth has spurred demand for computers, software, and information services, some of the principal growth sectors in the last quarter century.

The income gap is a challenge to the European welfare state. If they close their economies, by putting up trade barriers, to protect the welfare state, as many people believe they will do, inefficiency increases. The gap in real income will widen. At some point, the cost of the welfare state will become clearer. Some of their most productive workers will emigrate, as many have already done. Some of their corporations will relocate, as some Swedish corporations have done.

Until the 1980s, Great Britain was a prominent example of Keynesian and redistributive policies. As the heavy cost of these policies become more apparent, voters elected and re-elected a government that deregulated, privatized assets and lowered inflation. Voters chose higher living standards over more redistribution and regulation.

They did not throw out the welfare state, however. The role of government in education and health care increased. For a few years voters called a halt to the more liberal policies. Like voters in the United States, France, Germany, and elsewhere, they chose a candidate who promised some vague "third way."

I believe "the third way" is an admission of defeat by those who favor more redistribution, more regulation and higher tax rates. Rather than recognize that the policies they prefer have been rejected, leftist parties use a willing media to cover their defeat. The parties of the left are unwilling to articulate what the third way is or what they want.

Of course, they want power, but power to do what they do not say. In practice, they want what opinion polls and focus groups tell them to want. In the twentieth century, that has rarely been limited government.

The parties more disposed to limited government in principle do not act very differently from the others in practice. Perceived crisis or failure may for a time win support for a Reagan or a Thatcher, but even these exceptional leaders left few dents in the welfare state.

Although I have emphasized the role of the political center in shaping political outcomes, and collective choice, we should not take the current consensus as given. Our role as educators, yours and mine, is to move that consensus in the direction of free choice. Obvious failures of the welfare state in education, the provision of health care and pensions gives us splendid opportunities to show why choice and markets are superior to government control and direction. As in the defeat of socialism, we have not only the wisdom of Adam Smith on our side, we can offer more choice, more freedom, and better performance.