

# Obstacles to Free-Market Capitalism That Help Make Way for Socialism



By John B. Taylor, *George P. Shultz Senior Fellow in Economics, Hoover Institution*

In a book that George Shultz and I published this year, we explained why one must choose economic freedom, meaning basically the opposite of socialism.<sup>1</sup> Economic freedom, or free-market capitalism, the term of art used in this important Human Prosperity Project, means a rule of law, predictable policies, reliance on markets, attention to incentives, and limitations on government. Socialism means that the rule of law is replaced by arbitrary government actions, that policy predictability is no virtue, that market prices can be replaced by central decrees, that incentives matter little, and that government does not need to be restrained.

Choosing economic freedom is difficult. You need to watch for and remove obstacles such as those that were common in the 1950s and 1960s and grew worse in the 1970s. Federal Reserve Board chair Arthur Burns even wrote a memo to President Richard Nixon on June 22, 1971, calling for wage and price controls: yes, replacing market prices with central decrees. The effect was devastating. Inflation more than doubled, from 3.1 percent in the years 1961 through 1970 to 6.9 percent from 1971 through 1980, as the Fed let money growth increase. The inflation surge led President Gerald Ford to use “Whip Inflation Now” buttons in a joint session of Congress in 1974, but inflation kept rising. The unemployment rate also skyrocketed: it was 3.5 percent in 1969, 8.5 percent in 1975, and 9.7 percent in 1982.

Then President Ronald Reagan’s new obstacle-removing policies began to have an impact. Price controls were completely removed, market reforms were instituted, and the economy improved. Inflation came down, reaching 2 percent in 1985 and averaging 2.2 percent through the 1990s. Real economic growth also went up, from 2.5 percent from 1970 through 1982 to 3.7 percent from 1983 through 2000.

Now we hear renewed calls for government interventions and restrictions. Some of these are related to the effects of the terrible coronavirus, but others began earlier, including calls for occupational licensing, restrictions on wage and price setting, and government interventions in trade and supply chains. Even the Business Roundtable weighed in with a statement calling on management to look at the interests of a broader set of stakeholders, a big change from their 1997 statement, which said that that management’s main duty is to stockholders.<sup>2</sup> Some students in the Master

of Business Administration program at Stanford Graduate School of Business now even question the importance of profits.

With the demise of the Soviet Union, real-world case studies that showed the harms of excessive government intervention and central planning have been forgotten. It is understandable that students in my Economics 1 class at Stanford might not know about the harms of deviating from market principles: they were born long after the Soviet Union ceased to exist. Students sometimes ask me: “Why do we need to study market economics anymore? With artificial intelligence and machine learning, government can allocate people to the best jobs and make sure they get what they want.” This is why we need to teach history and focus on explaining and removing obstacles to free-market capitalism, which paved the way to socialism.

There are two kinds of obstacles on the road to free-market capitalism. First are *claims that first principles of free-market capitalism are wrong or do not work*.<sup>3</sup> Many made such claims in the 1940s and 1950s, when communist governments were taking hold and socialism was creeping up everywhere. R. M. Hartwell described the first meeting of the Mont Pelerin Society of free-market economists in this way: “The common objective of those who met at Mont Pelerin was undoubtedly to halt and reverse current political, social, and economic trends toward socialism.”<sup>4</sup> Despite many successes, these claims have returned today in renewed calls for socialism and criticism of free-market capitalism as a way to improve standards of living.

Second are *obstacles to bringing ideas into action* or political barriers to practical implementation of the principles of economic freedom. This second set of obstacles has also seen a revival in recent years in renewed calls by politically powerful vested interests for restrictions on school choice and government interventions.

## Obstacles That Claim the First Principles Are Wrong

How do we deal with doubts about the value of free-market capitalism? Much has already been written, but we need to go further. Milton Friedman—writing in 1994, long after publishing *Capitalism and Freedom* in 1961 and *Free to Choose* in 1979 with his wife, Rose—said this about Friedrich

Hayek's *The Road to Serfdom*: "This book has become a true classic: essential reading for everyone seriously interested in politics in the broadest and least partisan sense, a book whose central message is timeless, applicable to a wide variety of concrete situations. In some ways, it is even more relevant to the United States today than it was when it created a sensation on its original publication in 1944."<sup>5</sup> In the book, Hayek wrote:

Nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty . . . and to plan one's individual affairs on the basis of this knowledge.<sup>6</sup>

Hayek endeavored to explain the benefits of market-determined prices and the incentives they provide compared with central planning and government-administered prices. In his 1945 *American Economic Review* article "The Use of Knowledge in Society," he explained the value of markets, saying that solutions to

the problem we wish to solve when we try to construct a rational economic order . . . have been fully worked out and can be stated best in mathematical form: put at their briefest, they are that the marginal rates of substitution between any two commodities or factors must be the same in all their different uses. This, however, is emphatically not the economic problem which society faces. And the economic calculus which we have developed to solve this logical problem, though an important step toward the solution of the economic problem of society, does not yet provide an answer to it. The reason for this is that the "data" from which the economic calculus starts are never for the whole society "given" to a single mind which could work out the implications and can never be so given.<sup>7</sup>

Milton Friedman, writing in the *New York Times* in 1994, said, "The bulk of the intellectual community almost automatically favors any expansion of government power so long as it is advertised as a way to protect individuals from big bad corporations, relieve poverty, protect the environment or promote 'equality.' . . . The intellectuals may have learned the words, but they do not yet have the tune."<sup>8</sup>

There are many ways to build on these writings, to continue in these traditions today and to remove obstacles, whether by writing, speaking, teaching, or doing. I have long taught the basic Principles of Economics course at Stanford. It emphasizes that there are costs as well as benefits of government programs, that government failure—not just market failure—is a reality, that there are private remedies to

externalities, that the rule of law needs to be front and center if markets are to work, and that monetary and fiscal policy rules are good for both economic efficiency and liberty.<sup>9</sup> I have found it helpful to start off basic economic courses by setting up a series of participatory markets, or "double auctions," based on the innovative work of Vernon Smith and Charles Plott. Here students see how buyers and sellers set prices in a market and how prices serve as signals and provide information. This approach automatically introduces ideas such as consumer surplus and profits. Only then comes the model of supply and demand to explain and interpret these outcomes. The approach brings to students' minds the ideas in Hayek's 1945 *American Economic Review* article, including the concept that prices cannot be set at the center.

With the demise of the Soviet Union, some real-world case studies that many of us used to show the harms of central planning have been forgotten and are not easy to describe to students. It was helpful, for example, to show a famous cartoon from the old magazine *Krokodil* mocking how a Soviet production plant could fulfill centrally imposed plans by producing one 500-pound nail rather than 500 one-pound nails, even though the giant nail was useless, as explained by Elaine Schwartz.<sup>10</sup> It is important to update such stories and make them memorable for students, as David Henderson does in his *Joy of Freedom: An Economist's Odyssey*.<sup>11</sup>

There is also much that can be conveyed by using new data sets, which can help us to communicate more widely the benefits of economic freedom. *The Index of Economic Freedom*, published by the Heritage Foundation; *The Economic Freedom of the World* index, published by the Fraser Institute; and *Doing Business*, published by the World Bank, are put out annually. Stories in such publications about how good and bad economic outcomes correlate with good and bad policy provide a wonderful glimpse of what works and what does not. Such facts and stories can be added to course syllabi, lectures, speeches, and articles to help remove obstacles on the path.

### Obstacles to Bringing Ideas into Action

Even if we removed all obstacles claiming that the principles of economic freedom are wrong, there would still be additional obstacles to their implementation. To remove these additional obstacles requires that people take on the difficult task of implementing the principles in practice; as I have written elsewhere, "To get the job done, they [public officials] not only have to be clear about the principles, but also have to explain them, fight for them, and then decide when and how much to compromise on them."<sup>12</sup> As Milton Friedman said, "It is only a little overstated to say that we preach individualism and competitive capitalism, and practice socialism."<sup>13</sup>

Removing such obstacles usually means getting close to the political action, and this is one of the reasons I have taken on four stints in Washington over the years, each time returning afterward to the world of ideas. Of course, one needs to be careful when getting close to politics. I remember calling Milton Friedman from Washington in 1990 during my time at the Council of Economic Advisers. Friedman was then at the Hoover Institution at Stanford, and it was my job to ask him and others to support President George H. W. Bush's revenue enhancements, alternatively known as tax increases. I didn't even ask the question before he realized why I was calling and simply said, "No!" adding, "You better come back to Stanford right away, John. Washington is corrupting you."

There are many details involved in bringing ideas into action, so let me briefly go through some examples of successes or failures in removing such obstacles. I will draw on practical case studies discussed in Friedman's *Capitalism and Freedom* (1961) and *Free to Choose* (1979), as well as my book *First Principles* (2012). Each case study begins with a phrase drawn from one of those books, and page-number references are provided so that readers can seek more details. Douglas Irwin has given many good examples in international trade, so I will focus on other areas.<sup>14</sup>

### **"The Obstacles to a Voucher Plan"**

This is the title of a section on obstacles in *Free to Choose* (page 161). It focuses on a proposal to implement the ideas of economic freedom for all, and apply them in practice, by offering vouchers for students to attend alternative private or charter schools. As Milton and Rose Friedman point out in the book: "The perceived self-interest of the educational bureaucracy is the key obstacle to the introduction of market competition in schooling."

To confront and eventually remove this obstacle, they founded the Friedman Foundation for Educational Choice, which is now known as EdChoice.<sup>15</sup> It advocates for, and provides data on, school choice programs in many state and local communities in the United States. Results and practical information are provided in its book *123s of School Choice*.<sup>16</sup>

There are big educational differences among states in the United States, and a variety of obstacles as well, outlined in *Rich States, Poor States*, by Jonathan Williams, Arthur Laffer, and Stephen Moore.<sup>17</sup>

### **"International Monetary Arrangements . . . That a Liberal Cannot Afford to Neglect"**

This statement, on pages 56–57 of *Capitalism and Freedom*, usefully summarizes the importance of the international monetary system to the principles of economic freedom. Friedman makes the case for an international system with

(1) open capital markets; (2) flexible exchange rates between countries or blocs, with no intervention; and (3) rules-based monetary policy.

There are still many obstacles to the implementation of such a system, and they need to be removed. In recent years, capital controls for developing countries have been supported by the International Monetary Fund, and they are part of the IMF's new Institutional View and Capital Flow Management program. To some extent, these developments are a reaction to increased capital flow volatility caused by unconventional monetary policy actions, and they could naturally be removed by a return to rules-based policy.

The 2018 report of Eminent Persons Group on Global Financial Governance—on which I served—called for the eventual end of capital controls, and I hope the recommendation will be helpful in the removal process.<sup>18</sup> It is also helpful that many central bankers see the need for a reform of the international monetary system, though there is disagreement about how to proceed.

A promising finding is that research I reported elsewhere shows that a global rules-based monetary system could emerge—in the fashion of Hayekian "spontaneous order"—if each central bank around the world simply follows its own rules-based monetary policy and is transparent and accountable about doing so.<sup>19</sup> No international cooperation is needed other than a recognition of what will work in each country.

### **"Best Is a Flat-Rate Tax on Income above an Exemption"**

This proposal from *Capitalism and Freedom*, page 174, is very specific, and the book's arguments about why it would work are clear. Such a proposal for the tax system would satisfy the principles of economic freedom. Despite bouts of tax reform around the world, we are still far from such a flat tax system, but counting and tracking the removal of obstacles, as Robert Hall and Alvin Rabushka have done, is essential to further removal.<sup>20</sup>

The 2017 Tax Cuts and Jobs Act is an example of tax reform. It cut the corporate tax rate from 35 percent to 21 percent, cut the tax rate on small businesses, created a territorial tax system, and expanded the tax base by reducing the federal deduction for state and local taxes. The changes reduce the cost of capital and thus should raise investment, productivity, and people's incomes.

### **"A Veritable Explosion in Government Regulatory Activity . . . All Have Been Antigrowth"**

These phrases from *Free to Choose*, pages 180–181, are a rallying cry for obstacle removal. Removing regulations and

relying on markets in a solid cost-benefit manner are clearly consistent with the principles of free-market capitalism. Yet there have been a host of impediments to reform, often from special interests that benefit from regulations.

Again, keeping track of the obstacles removed and documenting the gains are essential if more obstacles are to be eliminated. Recent changes in regulatory activity in the United States provide good examples. The Congressional Review Act of 1996 has been used to eliminate regulations, and the Economic Growth, Regulatory Relief, Consumer Protection Act of 2018 lifted the threshold for stress test regulation from \$50 billion to \$250 billion. Legislation such as the Financial Institution Bankruptcy Act (Chapter 14) is still needed to end bailouts and the “too big to fail” problem.

### “Defusing the Debt Explosion”

This chapter title from *First Principles*, page 101, explains the need for a fiscal policy rule with budget balance over the cycle and makes several suggestions to reduce spending increases. These ideas have long been consistent with the principles of economic freedom and have taken various forms, including constitutional limits on the growth rate of government spending.

But the obstacles to implementation appear impenetrable and have been increasing, with few signs of removal. The growing federal spending and debt problems are nowhere near containment. Perhaps we can do better at explaining the need for budget reform. I have tried various things, even bringing my nine-month-old granddaughter to lectures to represent future generations. She later sensibly said, “Fix it,” but we haven’t, and she is now eleven years old. The coronavirus has worsened the situation, but, as Cogan, Heil and Taylor (2020) show, it is not too late for a change in fiscal policy that slows the growth of federal government spending without increasing taxes.<sup>21</sup>

### Concluding Remarks

In this paper, I have pointed out the many obstacles in the way of free-market capitalism. One can see some successful removals of obstacles over the years, both in explaining their dangers and removing them in practice. Examples include recent reductions in tax rates and cuts in regulations, though problems have continued in other areas, including the growing deficit.

But the recent COVID-19 pandemic and the public-health imperatives that have driven government policy have radically changed all of this, bringing many more challenges. Looking beyond today’s pandemic, we must develop a strategy that does not override markets—one that focuses on the removal of barriers to free-market capitalism and

thus avoids socialism. Implementation of such a strategy in practice will require a special emphasis on the private sector and markets.

That has been the main lesson of this paper: Keep markets free and open, and fight to remove obstacles that could pave the path toward socialism. We need to focus on new ways to open markets and to let new markets be created.

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# SOCIALISM AND FREE-MARKET CAPITALISM: THE HUMAN PROSPERITY PROJECT

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