Removing Obstacles on the Path to Economic Freedom[1]

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Mont Pelerin Society
Fort Worth, Texas

May 22, 2019

My remarks on removing obstacles on the path to economic freedom touch on themes raised at Mont Pelerin Society meetings for many years. But here I emphasize that the obstacles often change their form over time and pop up in surprising ways. I see two basic kinds of obstacles.

First are obstacles based *on claims that the principle ideas of economic freedom are wrong* or do not work. The principle ideas of economic freedom include *the rule of law, predictable policies, reliance on markets, attention to incentives,* and *limitations on government*.[2] This first kind of obstacle largely promotes the opposite of these principles, arguing that the rule of law should be 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.

Many were making such claims at the time that the Mont Pelerin Society was founded in 1947. Communist governments were taking hold. Socialism was creeping up everywhere. "The common objective of those who met at Mont Pelerin was undoubtedly to halt and reverse current political, social, and economic trends toward socialism," as R. M. Hartwell described the first meeting in his history of the Mont Pelerin Society.[3] Despite many successes, these claims have returned today in renewed calls for socialism and criticism of free market capitalism as a way to improved standards of living.

[1] Written version of remarks presented at the Mont Pelerin Society regional meeting in Fort Worth, Texas, May 22, 2019. Many thanks to Ben Powell and Bob Lawson for organizing the terrific Texas meeting intensely focused on "Contentious Issues in Classical Liberalism," and for thereby forging ahead with the good progress that defines the Mont Pelerin Society. And we have two more terrific meetings coming up: A general meeting on September 1-5, 2020 in Oslo—organized by Lars Peder Nordbakken—on "Liberal Institutions and the International Order: Renewing the Infrastructure of Freedom and Liberalism," and a special meeting on January 15-17, 2020 at Stanford's Hoover Institution—the home of the Mont Pelerin Society archives and Hayek and Friedman papers—on "From the Past to the Future: Ideas and Actions for a Free Society."
[2] John B. Taylor (2012), *First Principles: Five Keys to Restoring America's Prosperity*, W.W. Norton, New York
[3] R.M. Hartwell (1995), *A History of the Mont Pelerin Society*, Liberty Fund, Indianapolis p. 34

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

Obstacles that Claim the Principles of Economic Freedom are Wrong

From the time of its founding, and even in the years leading up to its founding, those who created the Mont Pelerin Society have been fighting false claims about the principles of economic freedom. It is worth starting by recalling what they said about these principles, for these statements often offer the best reply to the renewed false claims of the last few years.

While there have been disagreements among members of the Mont Pelerin Society, this is an area with little disagreement. Milton Friedman—writing in 1994 long after publishing *Capitalism and Freedom* in 1961 or *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 massage 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."[4] That was written at the time of the 50th anniversary of *The Road to Serfdom*. In my view, it is even more relevant today in 2019 on the 75th anniversary.

The founders of the Mont Pelerin Society often stressed the first two principles in the above list: the *rule of law* and *predictable policies*. Hayek in *The Road to Serfdom* wrote that "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."[5]

They 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," Hayek beautifully explained in economic terms the value of markets: The solutions of "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

[4] Friedman, Milton (1994a), "Introduction to the 1994 edition of *The Road to Serfdom*. Reprinted in *The Collected Works of F.A. Hayek, Volume II, The Road to Serfdom, Text and Documents, The Definitive Edition*, Bruce Caldwell (Ed.), University of Chicago Press, Chicago, 2007, p.259.
[5] Hayek, F.A. (1944) *The Road to Serfdom*, University of Chicago, Chicago. Reprinted in *The Collected Works of F.A. Hayek, Volume II, The Road to Serfdom, Text and Documents, The Definitive Edition*, Bruce Caldwell (Ed.), University of Chicago Press, Chicago, 2007, p. 112.

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."[6]

They also took on the view that a massive expansion of government power and spending was warranted. 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."[7]

There are many ways to continue in these traditions today and remove such obstacles to economic freedom, whether in writing, speaking, teaching, or doing. For example, I have long taught the basic principles of economics course at Stanford. The course emphasizes, in simple cost-benefit terms, that there are costs as well as benefits of government programs, that government failure is a reality, not just market failure, that there are private remedies to externalities, that the rule of law needs to be front and center if markets are to work, and, of course, that monetary and fiscal policy rules are good both for economic efficiency and liberty (as I discussed at another session at this meeting.[8])

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 prices set in a market by buyers and sellers (Econ 1 students) serve as signals and provide information. This approach automatically introduces ideas like consumer surplus and profits. Only then comes the model of supply and demand to explain and interpret these outcomes. The approach nicely brings to students' minds the ideas in Hayek's 1945 *American Economic Review* article including 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 are forgotten and not as easy to point to students. It was

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[6] Hayek, F.A. (1945), "The Use of Knowledge in Society," *American Economic Review,* 35, 4, September, pp. 519-39, reprinted in F.A. Hayek, *Individualism and Economic Order*, University of Chicago Press, Chicago, 1948.
[7] Friedman, Milton (1994b), "Once Again: Why Socialism Won't Work," *New York Times*, 13 August 1994. This article drew from the introductions to the 1971 and 1994 editions of *The Road to Serfdom*.
[8] Taylor, John B. (2019a), "Monetary Policy Rules for Efficiency and Liberty," presented at the panel on "Monetary Institutions and Policy in a Free Society" at the 2019 Texas meeting of the Mont Pelerin Society on "Contentious Issues in Classical Liberalism," May 2

helpful to discuss how Soviet production plants could fulfill centrally imposed plans by producing, for example, one 500-pound nail rather that 500 one-pound nails, even though the giant nail was useless. David Henderson (2002) shows how to update these old stories and make them memorable for students in *The Joy of Freedom: An Economist's Odyssey*.

There is also much that can be conveyed by using new large data sets, and these can help 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* by World Bank are put out annually. The stories in such publications about how good and bad economic outcomes in countries correlate nicely with good and bad policy provide a wonderful glimpse on what works and what does not. The facts and fascinating stories can easily be added to course syllabi, lectures, speeches and articles. They 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 were wrong, there would still be obstacles to the implementation of the principles. To remove these other obstacles requires that people take on the difficult task of implementing the principles in practice. "To get the job done, they 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."[9] As Milton Friedman said, "it is only a little overstated to say that we preach individualism and competitive capitalism, and practice socialism."[10]

Removing such obstacles usually means getting closer to the political action, and this is one of the reasons I took on four stints in Washington over the years, each time returning to the world of ideas. Of course, one needs to be careful when getting closer to the politics. I remember calling Milton Friedman on the phone from Washington in 1990 during a stint at the Council of Economic Advisers. Milton was at the Hoover Institution at Stanford. It was my job to ask him and others for support for President George H.W. Bush's "revenue enhancements," alternatively known as tax increases. I didn't even have to 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 to remove such obstacles, I will draw on practical case studies discussed in *Capitalism and Freedom (1961)*, *Free to Choose (1979)*, and my book *First Principles (2012).* For each example, I'll start with a phrase or section heading from one of those

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[9] Taylor, John B. (2012), *First Principles: Five Keys to Restoring America's Prosperity*, W. W. Norton, New York, p. 51.
[10] Friedman, Milton (1994a), "Introduction to the 1994 edition of The Road to Serfdom. Reprinted in *The Collected Works of F.A. Hayek, Volume II, The Road to Serfdom, Text and Documents, The Definitive Edition*, Bruce Caldwell (Ed.), University of Chicago Press, Chicago, 2007, p. 263

books with page number references for more details. Because Doug Irwin gave so many good examples at this meeting on international trade in his talk "Free Trade Family Feuds," I do not need to cover that important area where implementation is also so important.

"The Obstacles to a Voucher Plan"

This is the title of a whole section on obstacles in *Free to Choose* starting on page 161. The focus is on a proposal to implement the ideas of economic freedom for all and apply it in practice by offering vouchers for students to go to 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 by www.EdChoice.org. 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 the book *123s of School Choice* (2019) published by Ed Choice.

There are big educational differences among states in the United States—including more successes in Texas than in California, and this has resulted in differences in outcome as Chuck DeVore made clear in his talk at these meetings. And you can see even more differences in the series by Williams, Laffer, and Moore *Rich States, Poor States* (2019) which documents many of these obstacles among states. There is also a recent proposal at the federal level for Education Freedom Scholarships to remove obstacles by allowing for tax credits.

"*Monetary Rules Work and Discretion Doesn't*"

This is the title of a section of *First Principles* starting on page 121. We had a good session on this topic at these meetings, and although a few "contentious issues" remain, I think there is agreement that monetary policy rules satisfy the principles of economic freedom listed above.

But many obstacles in the path to policy rules have appeared over the years, and many were addressed by Milton Friedman in *Capitalism and Freedom*. There is evidence that monetary policy deviated from rules-based policy around the time of the great financial crisis, and thereby caused, deepened and prolonged the crisis.

There are now signs, however, that the obstacles are being removed: Appointments to the Fed of people sympathetic to rules, an active effort to normalize policy in practice, and speeches supporting rules-based policy including by the current chair and vice chair of the Federal Reserve Board, the vice chair of the Federal Reserve Board for supervision, and the vice chair of the Federal Open Market Committee.

A new and encouraging development during the past two years has been a detailed listing of policy rules by the Fed in its semi-annual *Monetary Policy Report*. Five such interest rate rules are listed in Table 1 on page 37 of the February 2019 *Report*. Take a look by clicking here: https://www.federalreserve.gov/monetarypolicy/files/20190222_mprfullreport.pdf

The statement in the 2019 *Report* that "The prescriptions for the policy interest rate from these rules can provide helpful guidance to the FOMC" is indicative that the rules are taken seriously. The *Report's* discussion of how policy rules relate to actual decisions is also helpful.

More could be done to formalize these developments. One of the rules in Table 1 of the Fed's *Report* incorporates adjustments to deal with the zero-lower bound on the interest rate, and there are currently debates about the use of negative interest rates. More transparency could be acheived by passing legislation along the lines of the bill "Requirements for Policy Rules for FOMC" which requires that the Federal Open Market Committee stipulate a rule of its own choosing for the instruments of policy. It has passed the House Financial Service Committee.

"***International monetary arrangements…that a liberal cannot afford to neglect***"

This statement appears on pages 56-57 of *Capitalism and Freedom*, and usefully summarizes the importance of the international monetary system is for the principles of economic freedom. Friedman made 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.

But 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. They are part of the IMFs' new "Institutional View" and "Capital Flow Management" program. To some extent, these developments are a reaction to the increased capital flow volatility caused by unconventional monetary policy actions, and they could naturally be removed by a return to rules-based policy.

The recent 2018 *Report of the G20 Eminent Persons Group*—on which I served—called for the eventual end of capital controls, and I hope the recommendation will be helpful in the removal process. 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 reported in Taylor (2019b) 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 followed its own rules-based monetary policy and was transparent and accountable about doing so. No international cooperation is needed other than a recognition of what would 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 arguments presented there 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 Hall and Rabushka (1985) have done, is essential to further removal.

The recently passed 2017 Tax Cuts and Jobs Act is an example. It cuts the corporate tax rate from 35 percent to 21 percent, cuts the tax rate on small businesses, creates a territorial tax system, and expands the tax base by reducing the federal deduction for state and local taxes. The changes would reduce the cost of capital, and thereby raise investment, productivity growth 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 the obstacle's removal. Removing regulation and relying more on markets in a solid cost-benefit manner is clearly consistent with the principles of economic freedom, yet there have been a host of impediments for reform, often from special interests who benefit from the regulations.

Again, keeping track of the obstacles removed and documenting the gains is essential if more obstacles are to be eliminated. Recent changes in regulatory activity in the United States provide good example. The Congressional Review Act has been used to eliminate or streamline regulations, the Economic Growth, Regulatory Relief, Consumer Protection Act lifted the threshold from $50 billion to $250 billion for stress test regulation. In my view, legislation is still needed, such as the Financial Institution Bankruptcy Act (sometimes called Chater14), to end bailouts and the too big to fail problem.

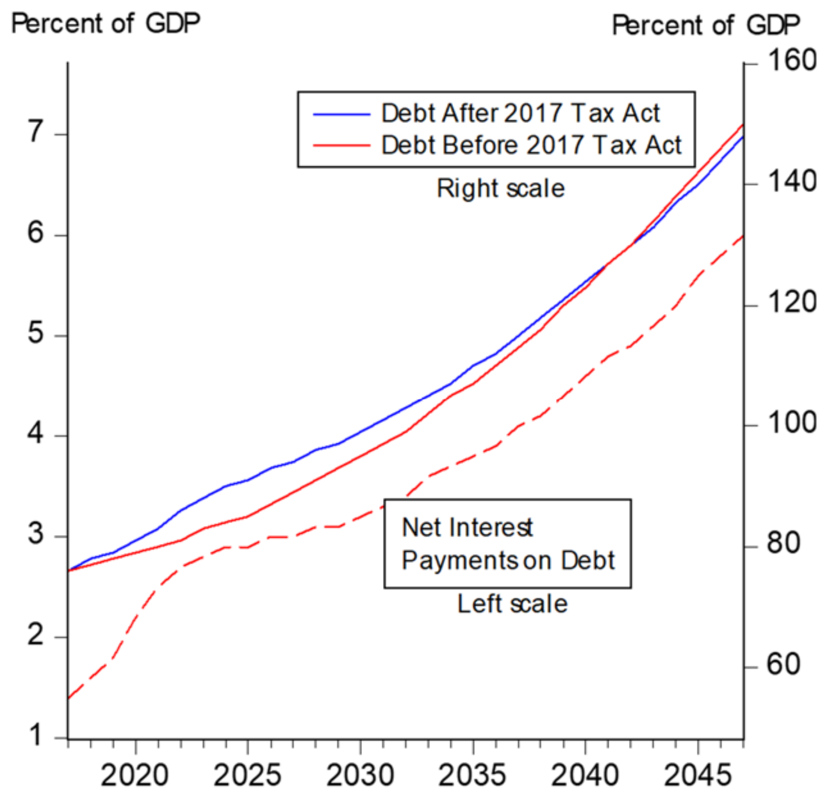
As in the case of monetary policy there have been many appointments of people who understand the benefits of the rule of law and predicable policy and who will consider the costs as well as benefits of regulations. Here I would include recent appointments to lead the Federal Communications Commission, the Security and Exchange Commissions, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Consumer Financial Protection Bureau, and the Department of Energy.

"***Defusing the Debt Explosion***"

This chapter title from *First Principles*, page 101, leads into a brief description of the need for a fiscal policy rule with budget balance over the cycle and with several suggestions to reduce the rate of spending increases. The 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 here the obstacles to implementation appear impenetrable and have been increasing with few signs of removal. Unfortunately, the federal deficit and federal debt problems are nowhere near being contained as is clear from the following chart based on data from the U.S. Congressional Budget Office. The chart shows that the debt continues to increase as a share of

GDP with or without the 2017 Tax Act, and that interest payments on the debt are rising rapidly. The chart tells the full story.



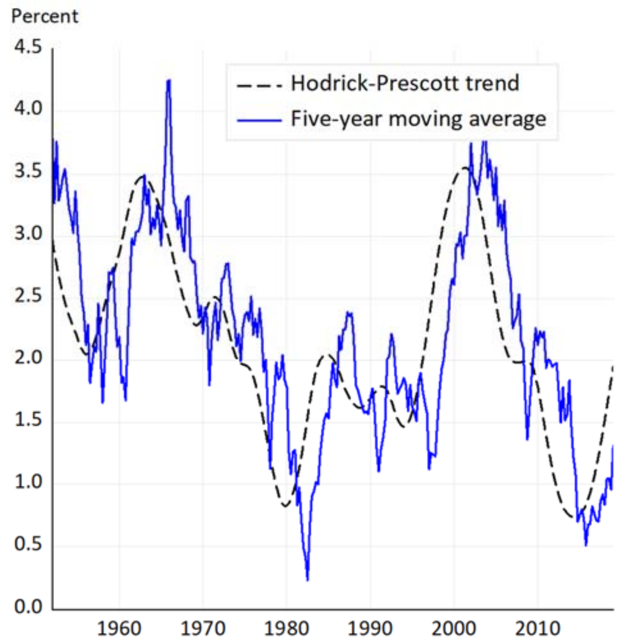
Perhaps we can do better at explaining the need for budget reform. I have tried various things, even bringing my 9-month-old granddaughter to lecture to represent future generations. She sensibly said, “fix it,” but we haven’t.

Concluding Remarks

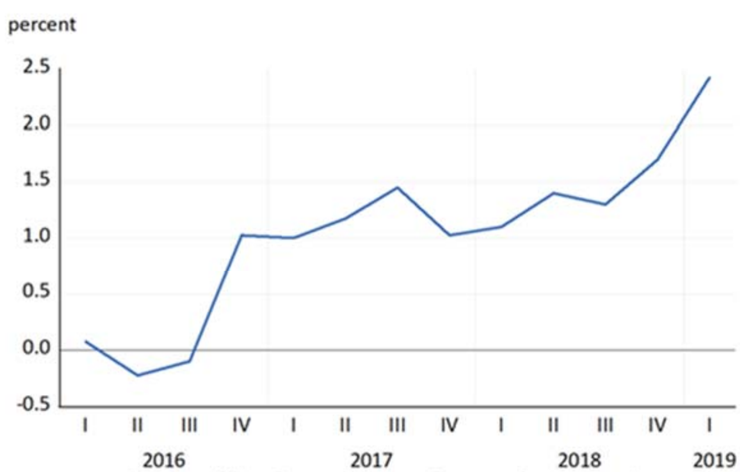
On this brief tour along the path to economic freedom, I have pointed out the many obstacles in the way. One can see some successes in removing the obstacles in recent years including a reduction in tax rates, cuts in regulation, and the beginnings of monetary reform. The verdict on international economic reform is still out, and there are concerns about the budget deficit. Nevertheless, one can see policy progress on balance.

Can one see corresponding progress on measurable results such as higher productivity growth? The two figures below suggest that the answer is yes. Over time one sees ups and downs in productivity growth which are closely correlated with changes in economic policy as I pointed out in *First Principles* (2012). The longer-term productivity trends in the chart are captured (1) by smoothing productivity over five years and (2) by taking out shorter-term movements using the Hodrick-Prescott method. Toward the end of the period, we see a reversal of the kind that basic policy analysis would project.

The second chart is a closeup. It shows recent productivity growth with one-year rather than five-year averages. Here one can see improvements. Whether this recent increase continues going forward depends very much on whether the obstacles on the path toward economic freedom discussed in this talk continue be removed going forward



Productivity growth



Productivity Growth from Quater One Year Ago
(nonfarm business)

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