

## The Thinkers of Liberty\*

- **John Locke (1632-1704)**

Born in England, John Locke was a persistent champion of natural rights—the idea that each person owns himself and should have certain liberties that cannot be expropriated by the state or anyone else. When someone labors for a productive end, the results become that person's property, reasoned Locke. His conclusion that labor contributes far more than nature to the value of goods was the first step toward the labor theory of value, as articulated by David Ricardo and Karl Marx.

Locke also believed that governments should not regulate interest rates. In a pamphlet titled *Considerations of the Consequences of the Lowering of Interest*, Locke opposed a bill before Parliament to lower the maximum legal interest rate from 6 percent to 4 percent. Because interest was a price, and because all prices are determined by the laws of nature, he reasoned, ceilings on interest rates would be counterproductive. People would evade the ceiling, and the costs of evasion would drive interest rates even higher than they would have been without the ceiling, he wrote. Locke's reasoning on the subject, sophisticated for his era, has stood the test of time: economists make the same objection to controls on interest rates today. (See [Interest](#), [PriceControls](#).)

Locke also sketched out a quantity theory of money, which held that the value of money was inversely related to the quantity of money in circulation. Locke erroneously believed that a country was in danger of falling into depression if its gold inflows from trade fell relative to those of its trade partners. What he did not realize, and what went unrealized until David Hume pointed it out, was that gold flows cannot get out of line with trade flows. If "too little" gold came into Britain relative to gold inflows to other countries, for example (Locke assumed that the supply of gold would grow relative to the volume of trade), then British goods would become cheap relative to other countries' goods, causing more gold to flow to England from other countries.

### Selected Works

*Several Papers Relating to Money, Interest and Trade, et cetera*. 1696. Reprint. 1968.  
*Two Treatises of Government*. 1690. Reprint, edited by Peter Laslett, 2d ed. 1953

- **Adam Smith (1723-90)**

With *The Wealth of Nations* Adam Smith installed himself as the fountainhead of contemporary economic thought. Currents of Adam Smith ran through David Ricardo and Karl Marx in the nineteenth century, and through Keynes and Friedman in the twentieth.

Adam Smith was born in a small village in Kirkcaldy, Scotland. There his widowed mother raised him until he entered the University of Glasgow at age fourteen, as was the usual practice, on scholarship. He later attended Balliol College at Oxford, graduating with an extensive knowledge of European literature and an enduring contempt for English schools.

He returned home, and after delivering a series of well-received lectures, was made first chair of logic (1751), then chair of moral philosophy (1752), at Glasgow University.

He left academia in 1764 to tutor the young duke of Buccleuch. For over two years they lived and traveled throughout France and into Switzerland, an experience that brought Smith into contact with contemporaries Voltaire, Jean-Jacques Rousseau, François Quesnay, and Anne-Robert-Jacques Turgot. With the life pension he had earned in the service of the duke, Smith retired to his birthplace of Kirkcaldy to write *The Wealth of Nations*. It was published in 1776, the same year the American Declaration of Independence was signed and in which his close friend David Hume died. In 1778 he was appointed commissioner of customs. This job put him in the uncomfortable position of having to curb smuggling, which, in *The Wealth of Nations*, he had upheld as a legitimate activity in the face of "unnatural" legislation. Adam Smith never married. He died in Edinburgh on July 19, 1790.

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Today Smith's reputation rests on his explanation of how rational self-interest in a free-market economy leads to economic well-being. It may surprise those who would discount Smith as an advocate of ruthless individualism that his first major work concentrated on ethics and charity. In fact, while chair at the University of Glasgow, Smith's lecture subjects, in order of preference, were natural theology, ethics, jurisprudence, and economics, according to John Millar, Smith's pupil at the time. In *The Theory of Moral Sentiments*, Smith wrote: "How selfish soever man may be supposed, there are evidently some principles in his nature which interest him in the fortune of others and render their happiness necessary to him though he derives nothing from it except the pleasure of seeing it."

At the same time, Smith had a benign view of self-interest. He denied the view that self-love "was a principle which could never be virtuous in any degree." Smith argued that life would be tough if our "affections, which, by the very nature of our being, ought frequently to influence our conduct, could upon no occasion appear virtuous, or deserve esteem and commendation from anybody." To Smith sympathy and self-interest were not antithetical; they were complementary. "Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only," he explained in *The Wealth of Nations*.

Charity, while a virtuous act, could not alone provide the essentials for living. Self-interest was the mechanism that could remedy this shortcoming. Said Smith: "It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest."

Someone earning money by his own labor benefits himself. Unknowingly, he also benefits society, because to earn income on his labor in a competitive market, he must produce something others value. In Adam Smith's lasting imagery, "By directing that industry in such a manner as its produce may be of greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."

The five-book series of *The Wealth of Nations* sought to reveal the nature and cause of a nation's prosperity. The main cause of prosperity, argued Smith, was increasing division of labor. Smith gave the famous example of pins. He asserted that ten workers could produce 48,000 pins per day if each of eighteen specialized tasks was assigned to particular workers. Average productivity: 4,800 pins per worker per day. But absent the division of labor, a worker would be lucky to produce even one pin per day.

Just how individuals can best apply their own labor or any other resource is a central subject in the first book of the series. Smith claimed that an individual would invest a resource, for example, land or labor, so as to earn the highest possible return on it. Consequently, all uses of the resource must yield an equal rate of return (adjusted for the relative riskiness of each enterprise). Otherwise reallocation would result. This idea, wrote George Stigler, is the central proposition of economic theory. Not surprisingly, and consistent with another Stigler claim that the originator of an idea in economics almost never gets the credit, Smith's idea was not original. French economist Turgot had made the same point in 1766.

Smith used this insight on equality of returns to explain why wage rates differed. Wage rates would be higher, he argued, for trades that were more difficult to learn, because people would not be willing to learn them if they were not compensated by a higher wage. His thought gave rise to the modern notion of human capital (see human capital). Similarly, wage rates would also be higher for those who engaged in dirty or unsafe occupations (see job safety), such as coal mining and butchering, and for those, like the hangman, who performed odious jobs. In short, differences in work were compensated by differences in pay. Modern economists call Smith's insight the theory of compensating wage differentials.

Smith used numeraire economics not just to explain production of pins or differences in pay between butchers and hangmen, but to address some of the most pressing political issues of the day. In the fourth book of *The Wealth of Nations*—published, remember, in 1776—Smith tells Great Britain that her American colonies are not worth the cost of keeping. His reasoning about the excessively high cost of British imperialism is worth repeating, both to show Smith at his numeraire best, and to show that simple clear economics can lead to radical conclusions:

A great empire has been established for the sole purpose of raising up a nation of customers who should be obliged to buy from the shops of our different producers all the goods with which these could supply them. For the sake of that little enhancement of price which this monopoly might afford our producers, the home-consumers have been burdened with the whole expense of maintaining and defending that empire. For this purpose, and for this purpose only, in the two last wars, more than a

hundred and seventy millions has been contracted over and above all that had been expended for the same purpose in former wars. The interest of this debt alone is not only greater than the whole extraordinary profit, which, it ever could be pretended, was made by the monopoly of the colony trade, but than the whole value of that trade, or than the whole value of the goods, which at an average have been annually exported to the colonies.

Smith vehemently opposed mercantilism—the practice of artificially maintaining a trade surplus on the erroneous belief that doing so increased wealth. The primary advantage of trade, he argued, was that it opened up new markets for surplus goods and also provided some commodities at less cost from abroad than at home. With that, Smith launched a succession of free trade economists and paved the way for David Ricardo's and John Stuart Mill's theories of comparative advantage a generation later.

Adam Smith has sometimes been caricatured as someone who saw no role for government in economic life. In fact, he believed that government had an important role to play. Like most modern believers in free markets, Smith believed that the government should enforce contracts and grant patents and copyrights to encourage inventions and new ideas. He also thought that the government should provide public works, such as roads and bridges, that, he assumed, would not be worthwhile for individuals to provide. Interestingly, though, he wanted the users of such public works to pay in proportion to their use. One definite difference between Smith and most modern believers in free markets is that Smith favored retaliatory tariffs.

Retaliation to bring down high tariff rates in other countries, he thought, would work. "The recovery of a great foreign market," he wrote "will generally more than compensate the transitory inconvenience of paying dearer during a short time for some sorts of goods."

Some of Smith's ideas are testimony to his breadth of imagination. Today, vouchers and school choice programs are touted as the latest reform in public education. But it was Adam Smith who addressed the issue more than two hundred years ago:

Were the students upon such charitable foundations left free to choose what college they liked best, such liberty might contribute to excite some emulation among different colleges. A regulation, on the contrary, which prohibited even the independent members of every particular college from leaving it, and going to any other, without leave first asked and obtained of that which they meant to abandon, would tend very much to extinguish that emulation.

Smith's own student days at Oxford (1740-46), whose professors, he complained, had "given up altogether even the pretense of teaching," left Smith with lasting disdain for the universities of Cambridge and Oxford.

Smith's writings were both an inquiry into the science of economics and a policy guide for realizing the wealth of nations. Smith believed that economic development was best fostered in an environment of free competition that operated in accordance with universal "natural laws." Because Smith's was the most systematic and comprehensive study of economics up until that time, his economic thinking became the basis for classical economics. And because more of his ideas have lasted than those of any other economist, Adam Smith truly is the alpha and the omega of economic science.

### **Selected Works**

*An Inquiry into the Nature and Causes of the Wealth of Nations*, edited by Edwin Cannan. 1976.  
*The Theory of Moral Sentiments*, edited by D. D. Raphael and A. L. Macfie. 1976.

- **John Stuart Mill (1806-73)**

The eldest son of economist James Mill, John Stuart Mill was educated according to the rigorous expectations of his Benthamite father. He was taught Greek at age three and Latin at age eight. By the time he reached young adulthood, John Stuart Mill was a formidable intellectual, albeit an emotionally depressed one. After recovering from a nervous breakdown, he departed from his Benthamite teachings to shape his own view of political economy. He wrote *Principles of Political Economy*, which became the leading economics textbook for forty years after it was written. In it Mill elaborated on the ideas of David Ricardo and Adam Smith. He helped develop the ideas of economies of scale, opportunity cost, and comparative advantage in trade.

Mill was a strong believer in freedom, especially of speech and of thought. He defended freedom on two grounds. First, he argued, society's utility would be maximized if each person was free to make

his or her own choices. (The "her" is particularly appropriate. Mill strongly believed, possibly due to the influence of his wife, Harriet Taylor, whom he idolized, that women were the equals of men. His book *The Subjection of Women* attacked the contemporary view of women's inherent inferiority.) Second, Mill believed that freedom was required for each person's development as a whole person. In his famous essay *On Liberty*, Mill enunciated the principle that "the sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is self-protection." He wrote that we should be "without impediment from our fellow-creatures, so long as what we do does not harm them, even though they should think our conduct foolish, perverse, or wrong."

Surprisingly, though, Mill was not a consistent advocate of laissez-faire. His biographer, Alan Ryan, conjectures that Mill did not think of freedom of contract and property rights as being part of freedom. Mill favored inheritance taxation, trade protectionism, and regulation of employees' hours of work. Interestingly, although Mill favored mandatory education, he did not advocate mandatory schooling. Instead, he advocated a voucher system for schools and a state system of exams to ensure that people had reached a minimum level of learning.

Although Mill advocated universal suffrage, he suggested that the better-educated voters be given more votes. He emphatically defended this proposal from the charge that it was intended to let the middle class dominate. He argued that it would protect against class legislation and that anyone who was educated, including poor people, would have more votes.

Mill spent most of his working life with the East India Company. He joined it at age sixteen and worked there for thirty-eight years. He had little effect on policy, but his experience did affect his views on self-government.

### **Selected Works**

*Essays on Some Unsettled Questions of Political Economy*, 1844.

*Essays on Some Unsettled Questions of Political Economy*, Second edition, 1874.

*Principles of Political Economy, with Some of Their Applications to Social Philosophy*, 2 vols. 1848.

*On Liberty*. 1859.

*On Liberty*, Fourth edition, 1869.

*Considerations on Representative Government*. 1861.

*The Subjection of Women*. 1869.

- **Carl Menger (1840-1921)**

Carl Menger has the twin distinction of being the founder of Austrian economics and a cofounder of the marginal utility revolution. Menger worked separately from William Jevons and Leon Walras and reached similar conclusions by a different method. Unlike Jevons, Menger did not believe that goods provide "utils," or units of utility. Rather, he wrote, goods were valuable because they served various uses whose importance differed. For example, the first pails of water are used to satisfy the most important uses, and successive pails are used for less and less important purposes.

Menger used this insight to resolve the diamond-water paradox that had baffled Adam Smith (see Marginalism). He also used it to refute the labor theory of value. Goods acquired their value, he showed, not because of the amount of labor used in producing them, but because of their ability to satisfy people's wants. Indeed, Menger turned the labor theory of value on its head. If the value of goods is determined by the importance of the wants they satisfy, then the value of labor and other inputs of production (he called them "goods of a higher order") derived from their ability to produce these goods. Mainstream economists still accept this theory.

Menger used his "subjective theory of value" to arrive at one of the most powerful insights in economics: both sides gain from exchange, or in modern jargon, exchange is a positive-sum game. People will exchange something that they value less for something they value more. Because both trading partners do this, both gain. This insight led him to see that middlemen are highly productive: they facilitate transactions that benefit those they buy from and those they sell to. Without the middlemen these transactions either would not have taken place or would have been more costly.

Menger also came up with an explanation of how money develops that is still accepted today. If people barter, he pointed out, then they can rarely get what they want in one or two transactions. If they have lamps and want chairs, for example, they will not necessarily be able to trade lamps for chairs but

must instead make a few intermediate trades. This is a hassle. But people notice that the hassle is much less when they trade what they have for some good that is widely accepted, and then use this good to buy what they want. The good that is widely accepted eventually becomes money. Indeed, the word *pecuniary* derives from the Latin *pecus*, meaning cattle, which in some societies served as money. Other societies have used cigarettes, cognac, salt, furs, or stones as money. As economies became more complex and wealthier, they began to use precious metals (gold, silver, and so on) as money.

Menger extended his analysis to other institutions. He argued that language, for example, developed for the same reason money developed—to make interaction between people easier. He noted that neither language nor money was developed by government. He called such developments "organic."

The Austrian school of economic thought first coalesced from Menger's writings and those of two young disciples, Eugen von Böhm-Bawerk and Friedrich von Wieser. Later Austrian economists Ludwig von Mises and Friedrich Hayek, used Menger's insights as a starting point, Mises with his work on money and Hayek with his idea of "spontaneous order."

Carl Menger was born in Galicia, part of Austro-Hungary (now southern Poland), to a prosperous family. He was one of three talented brothers; Anton was a legal philosopher and socialist historian, and Karl was a prominent mathematician. Carl earned his doctorate in law from the University of Krakow in 1867. As a result of publishing his *Principles of Economics* in 1871, he was given a lectureship and then a professorship at the University of Vienna, which he held until 1903. In 1876 he took a tutoring post for the Crown Prince Rudolf of Austria. In that capacity he traveled throughout Germany, France, Switzerland, and England.

### **Selected Works**

"On the Origin of Money." *Economic Journal* 2 (June 1892): 239-55.

*Principles of Economics*. 1871. Translated by J. Dingwall and B. F. Hoselitz, with an introduction by Friedrich A. Hayek. 1981.

- **Eugen von Böhm-Bawerk (1851-1914)**

Eugen von Böhm-Bawerk was one of the leading members of the Austrian school of economics—an approach to economic thought founded by Carl Menger and augmented by Knut Wicksell, Ludwig von Mises, Friedrich A. Hayek, and Sir John Hicks. Böhm-Bawerk's work became so well known that before World War I, his Marxist contemporaries regarded the Austrians as their typical bourgeois, intellectual enemy. His theories of interest and capital were catalysts in the development of economics, but today little attention is paid to his original work.

Böhm-Bawerk gave three reasons why interest rates were positive. First, people's marginal utility of income will fall over time because they expect higher income in the future. Second, for psychological reasons the marginal utility of a good declines with time. For both reasons, which economists now call "positive time-preference," wrote Böhm-Bawerk, people were willing to pay positive interest rates to get access to resources in the present, and insisted on being paid interest to give up such access. Economists have accepted both as valid reasons for positive time-preference.

But Böhm-Bawerk's third reason—the "technical superiority of present over future goods"—was more controversial and harder to understand. Production, he noted, is "round-about," meaning that it takes time. It uses capital, which is produced, to transform nonproduced factors of production—such as land and labor—into output. Roundabout production methods mean that the same amount of input can yield a greater output. Böhm-Bawerk reasoned that the net return to capital was the result of the greater value produced by roundaboutness.

An example helps illustrate the point. As the leader of a primitive fishing village, you are able to send out the townspeople to catch enough fish, with their bare hands, to ensure the village's survival for one day. But if you forgo consumption of fish for one day and use that labor to produce nets, hooks, and lines—capital—each fisherman can catch more fish the following day and the days thereafter. Capital is productive.

Further investment in capital, argued Böhm-Bawerk, increases roundaboutness, i.e., lengthens the production period. On this basis Böhm-Bawerk concluded that the net physical productivity of capital would lead to positive interest rates even if the first two reasons did not hold.

Although his theory of capital is one of the cornerstones of Austrian economics, modern mainstream economists pay no attention to Böhm-Bawerk's analysis of roundaboutness. Instead, they accept Irving Fisher's approach of just assuming that there are investment opportunities that make capital productive. Nevertheless, Böhm-Bawerk's approach helped to pave the way for modern interest theory.

Böhm-Bawerk was also one of the first economists to discuss Karl Marx's views seriously. He argued that interest does not exist due to exploitation of workers. Workers would get the whole of what they helped produce only if production were instantaneous. But because production is roundabout, he wrote, some of the product that Marx attributed to workers must go to finance this roundaboutness, i.e., must go to capital. Böhm-Bawerk noted that interest would have to be paid no matter who owned the capital. Mainstream economists still accept this argument.

Böhm-Bawerk was born in Vienna and studied law at the university there. After teaching at the University of Innsbruck and serving in the civil service, he was appointed minister of finance during the years 1895, 1897, and 1900. He left the ministry in 1904 and taught economics at the University of Vienna until his death in 1914.

### **Selected Works**

*Capital and Interest*, 1890. London: Macmillan and Co. Tr. by William Smart.

Reprint. 1959.

*The Positive Theory of Capital*, 1891. London: Macmillan and Co. Tr. by William Smart.

*Shorter Classics*. 1962.

- **Ludwig Edler von Mises (1881-1973)**

Ludwig von Mises was one the last members of the original Austrian school of economics. He earned his doctorate in law and economics from the University of Vienna in 1906. One of his best works, *The Theory of Money and Credit*, was published in 1912. In that book, which was used as a money and banking textbook for the next two decades, Mises extended Austrian marginal utility theory to money. Money, noted Mises, is demanded for its usefulness in purchasing other goods, rather than for its own sake.

In that same book Mises also argued that business cycles were caused by the uncontrolled expansion of bank credit. In 1926 Mises founded the Austrian Institute for Business Cycle Research. His most influential student, who later developed Mises' business cycle theories, was Friedrich Hayek.

Another notable contribution by Mises was his claim that socialism must fail economically. In a 1920 article Mises argued that a socialist government could not make the economic calculations required to organize a complex economy efficiently. Although socialist economists Oskar Lange and Abba Lerner disagreed with Mises, modern economists agree that Mises' argument, combined with Hayek's elaboration of it, is correct (see Socialism).

Mises believed that economic truths are derived from self-evident axioms and cannot be empirically tested. In his magnum opus, *Human Action*, and in other publications, Mises laid out these views. His view failed to persuade many economists outside the Austrian school. Mises was also a strong proponent of laissez-faire; he advocated that the government not intervene anywhere in the economy. Interestingly, though, even Mises made some striking exceptions to this view. For example, he believed that military conscription could be justified in wartime.

Mises was rare, for someone of his stature within the economics profession, in not having a paying academic job for much of his professional life. From 1913 to 1934 Mises was an unpaid professor at the University of Vienna. His salaried job from 1909 to 1934 was as an economist for the Vienna Chamber of Commerce, in which capacity he served as the principal economic adviser to the Austrian government. To avoid the Nazi influence in his Austrian homeland, in 1934 Mises left for Geneva, where he was a professor at the Graduate Institute of International Studies until 1940. In 1940 he emigrated to New York City. He was a visiting professor at New York University from 1948 until he retired in 1969. During those years his salary was paid by a private foundation.

Not only did Mises not have a regular tenure-track academic job, but his ideas—on economic reasoning and on economic policy—were out of fashion during the Keynesian revolution that took over American economic thinking from the midthirties to the sixties. Possibly both factors made Mises bitter from the late forties on, something that was not true early in his professional life. The contrast between his early view of himself as a mainstream member of his profession and his later view of himself as an

outcast shows up starkly in *The Theory of Money and Credit*. The first section, written in 1912, is calmly argued; the last section, added in the forties, is strident.

Mises had a strong influence on young people. A resurgent Austrian school in the United States owes itself in no small part to Mises' persistence.

### **Selected Works**

"Economic Calculation in the Socialist Commonwealth." 1920. Reprinted in *Collectivist Economic Planning: Critical Studies on the Possibilities of Socialism*, edited by Friedrich Hayek. 1935.

Mises, Ludwig von. *Human Action: A Treatise on Economics*. 1949.

*Human Action: A Treatise on Economics*, 3d ed. 1966.

*Human Action: A Treatise on Economics*. Fourth revised ed., 1996.

*Omnipotent Government: The Rise of the Total State and Total War*. 1944. Reprint. 1985.

*The Theory of Money and Credit*. 1912. 3d English ed. 1981.

*Finance and Banking in the Austrian Empire and Republic of Austria*, two articles from the 12th edition of the *Encyclopedia Britannica*

*Socialism*. 1922.

- **Friedrich August Hayek (1899-1992)**

If any twentieth-century economist was a Renaissance man, it was Friedrich Hayek. He made fundamental contributions in political theory, psychology, and economics. In a field where the relevance of ideas often is eclipsed by expansions on an initial theory, many of his contributions are so remarkable that people still read them over forty years after they were written. Many graduate economics students today, for example, study his articles from the thirties and forties on economics and knowledge, deriving insights that some of their elders in the economics profession still do not totally understand. It would not be surprising if a substantial minority of economists still read and learn from his articles in the year 2050.

Hayek was the best-known advocate of what is now called Austrian economics. He was, in fact, the only major recent member of the Austrian school who was actually born and raised in Austria. After World War I Hayek earned his doctorates in law and political science at the University of Vienna. Afterward he, together with other young economists, Gottfried Haberler, Fritz Machlup, and Oskar Morgenstern, joined Ludwig von Mises's private seminar—the Austrian equivalent of Keynes's "Cambridge Circus." In 1927 Hayek became the director of the newly formed Austrian Institute for Business Cycle Research. In the early thirties, at the invitation of Lionel Robbins, he moved to the faculty of the London School of Economics, where he stayed for eighteen years. He became a British citizen in 1938.

Most of Hayek's work from the twenties through the thirties was in the Austrian theory of business cycles, capital theory, and monetary theory. Hayek saw a connection among all three. The major problem for any economy, he argued, is how people's actions are coordinated. He noticed, as Adam Smith had, that the price system—free markets—did a remarkable job of coordinating people's actions, even though that coordination was not part of anyone's intent. The market, said Hayek, was a spontaneous order. By spontaneous, Hayek meant unplanned—the market was not designed by anyone but evolved slowly as the result of human actions. But the market does not work perfectly. What causes the market, asked Hayek, to fail to coordinate people's plans, so that at times, large numbers of people are unemployed?

One cause, he said, was increases in the money supply by the central bank. Such increases, he argued in *Prices and Production*, would drive down interest rates, making credit artificially cheap. Businessmen would then make capital investments that they would not have made had they understood that they were getting a distorted price signal from the credit market. But capital investments, noted Hayek, are not homogeneous. Long-term investments are more sensitive to interest rates than short-term ones, just as long-term bonds are more interest-sensitive than Treasury bills. Therefore, he concluded, artificially low interest rates not only cause investment to be artificially high, but also cause "malinvestment"—too much investment in long-term projects relative to short-term ones. He argued that the boom must turn into a bust. Hayek saw the bust as a healthy and necessary readjustment. The way to avoid the busts, he argued, was to avoid the booms that caused them.

Hayek and Keynes were building their models of the world at the same time. They were familiar with each other's views and battled over their differences. Most economists believe that Keynes's

General Theory won the war. Hayek, until his dying day, never believed that, and neither do other members of the Austrian school. Hayek believed that Keynesian policies to combat unemployment would inevitably cause inflation, and that to keep unemployment low, the central bank would have to increase the money supply faster and faster, causing inflation to get higher and higher. Hayek's thought, which he expressed as early as 1958, is now accepted by mainstream economists (see [Phillips Curve](#)).

In the late thirties and early forties Hayek turned to the debate about whether socialist planning could work. He argued that it could not. The reason socialist economists thought central planning could work, argued Hayek, was that they thought planners could take the given economic data and allocate resources accordingly. But Hayek pointed out that the data are not "given." The data do not exist, and cannot exist, in any one mind or small number of minds. Rather, each individual has knowledge about particular resources and potential opportunities for using these resources that a central planner can never have. The virtue of the free market, argued Hayek, is that it gives the maximum latitude for people to use information that only they have. In short, the market process generates the data. Without markets, data are almost nonexistent.

Mainstream economists and even many socialist economists (see [Socialism](#)) now accept Hayek's argument. Harvard economist Jeffrey Sachs has stated: "If you ask an economist where's a good place to invest, which industries are going to grow, where the specialization is going to occur, the track record is pretty miserable. Economists don't collect the on-the-ground information businessmen do. Every time Poland asks, Well, what are we going to be able to produce? I say I don't know."

In 1944 Hayek also attacked socialism from a very different angle. From his vantage point in Austria, Hayek had observed Germany very closely in the twenties and early thirties, and then moved to Britain. He noticed that many British socialists were advocating some of the same policies for government control of people's lives that he had seen advocated in Germany in the twenties. He had also seen that the Nazis really were National Socialists—that is, they were nationalists and socialists. So Hayek wrote *The Road to Serfdom* to warn his fellow British citizens of the dangers of socialism. His basic argument was that government control of our economic lives amounts to totalitarianism—total government control of our lives. Wrote Hayek: "Economic control is not merely control of a sector of human life which can be separated from the rest: it is the control of the means for all our ends."

Surprisingly to some, John Maynard Keynes praised the book highly. On the book's cover, Keynes is quoted as saying: "In my opinion it is a grand book.... Morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in deeply moved agreement."

Although Hayek had intended *The Road to Serfdom* only for a British audience, it also sold well in the United States. Indeed, Reader's Digest condensed it. With that book Hayek established himself as the world's leading classical liberal, now called libertarian or market liberal. A few years later, along with Milton Friedman, George Stigler, and others, he formed the Mont Pelerin Society so that classical liberals could meet every two years and give each other moral support in what appeared to be a losing cause.

In 1950 Hayek became professor of social and moral sciences at the University of Chicago, where he stayed until 1962. During that time he worked on methodology, psychology, and political theory. In methodology Hayek attacked "scientism"—the imitation in social science of the methods of the physical sciences. His argument was that because social science, including economics, studies people and not objects, it can do so only by paying attention to human purposes. The Austrian school in the 1870s had already shown that the value of an item derives from its ability to fulfill human purposes. Hayek was arguing that social scientists more generally should take account of human purposes. His thoughts on the matter are in *The Counter-Revolution of Science: Studies in the Abuse of Reason*. In psychology Hayek wrote *The Sensory Order: An Inquiry into the Foundations of Theoretical Psychology*.

In political theory Hayek gave his view of the proper role of government in his book *The Constitution of Liberty*. He discussed the principles of freedom and based his policy proposals on those principles. His main objection to progressive taxation, for example, was not that it causes inefficiency but that it violates equality before the law. In the book's postscript, "Why I Am Not a Conservative," Hayek distinguished his classical liberalism from conservatism. Among his grounds for rejecting conservatism were that moral and religious ideals are not "proper objects of coercion" and that conservatism is hostile to internationalism and prone to a strident nationalism.

In 1962 Hayek returned to Europe as professor of economic policy at the University of Freiburg in Breisgau, West Germany, and stayed there until 1968. He then taught at the University of Salzburg in

Austria until his retirement nine years later. His publications slowed substantially in the early seventies. In 1974 he shared the Nobel Prize with Gunnar Myrdal for his theories of money and his illumination of the "interdependence of economic, social, and institutional phenomena." This award seemed to breathe new life in him, and he began publishing again, both in economics and in politics.

Many people get more conservative as they age. Hayek became more radical. Although he had favored central banking for most of his life, in the seventies he began advocating denationalizing money. Private enterprises that issued distinct currencies, he argued, would have an incentive to maintain their currency's purchasing power. Customers could choose from among competing currencies, and whether they reverted to a gold standard was a question that Hayek was too much of a believer in spontaneous order to predict. With the collapse of communism in Eastern Europe, some economic consultants have considered Hayek's currency system as a replacement for fixed-rate currencies.

Hayek was still publishing at age eighty-nine. In his book *The Fatal Conceit*, he laid out some profound insights to explain the intellectuals' attraction to socialism and then refuted the basis for their beliefs.

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- **James M. Buchanan (1919- )**

James Buchanan is the cofounder, along with Gordon Tullock, of public choice theory (see Public Choice Theory). Buchanan entered the University of Chicago's graduate economics program as a "libertarian socialist." After six weeks of taking Frank Knight's course in price theory, recalls Buchanan, he had been converted into a zealous free marketer.

Buchanan's next big conversion came while reading an article in German by Swedish economist Knut Wicksell. The obscure 1896 article's message was that only taxes and government spending that are unanimously approved can be justified. That way, argued Wicksell, taxes used to pay for programs would have to be taken from those who benefited from those programs. Wicksell's idea contradicted the mainstream forties' view, still the mainstream view, that there need be no connection between what a taxpayer pays and what he receives in benefits. But Buchanan found it persuasive. He translated the essay into English and started thinking more along Wicksell's lines.

One of the products of his thinking was a book, coauthored with Gordon Tullock, titled The Calculus of Consent. They showed that the unanimity requirement is unworkable in practice. They then considered modifications to the rule, what they called "workable unanimity." Their book, along with Anthony Downs's *An Economic Theory of Democracy*, helped start the field of public choice and is now considered a classic. Together, Buchanan and Tullock also started the academic journal *Public Choice*.

Perhaps Buchanan's most important contribution to economics is his distinction between two levels of public choice—the initial level at which a constitution is chosen, and the postconstitutional level. The first is like setting rules of a game, and the second is like playing the game within the rules.

Buchanan has proselytized his fellow economists to think more about the first level instead of mucking about as political players at the second level. To spread this way of thinking, Buchanan has even started a new journal called *Constitutional Economics*.

Buchanan also believes that because costs are subjective, much of welfare economics—cost-benefit analysis, and so on—is wrongheaded. He spells out these views in detail in Cost and Choice, an

uncommonly impassioned economics book. Yet Buchanan has not persuaded most of his economist colleagues on this issue.

Buchanan was awarded the 1986 Nobel Prize in economics for "his development of the contractual and constitutional bases for the theory of economic and political decision making." Buchanan is a southerner and proud of his heritage. He was born in Murfreesboro, Tennessee, and has spent most of his academic life in Virginia, first at the University of Virginia, then at Virginia Polytechnic Institute and State University, and most recently, at George Mason University. In 1969 Buchanan became the first director of the Center for the Study of Public Choice. He was president of the Southern Economic Association in 1963 and of the Western Economic Association in 1983 and 1984, and vice president of the American Economic Association in 1971.

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- **Milton Friedman (1912- )**

Milton Friedman is the twentieth century's most prominent economist advocate of free markets. He was born in 1912 to Jewish immigrants in New York City. He attended Rutgers University, where he received his B.A. at the age of twenty, then went on to earn his M.A. from the University of Chicago in 1933 and his Ph.D. from Columbia University in 1946. In 1951 Friedman won the John Bates Clark Medal honoring economists under age forty for outstanding achievement. In 1976 he won the Nobel Prize in economics for "his achievements in the field of consumption analysis, monetary history and theory, and for his demonstration of the complexity of stabilization policy." Before that time, he had served as an adviser to President Nixon and was president of the American Economic Association in 1967. Since retiring from the University of Chicago in 1977, Friedman has been a senior research fellow at the Hoover Institution at Stanford University.

Friedman established himself in 1945 with *Income from Independent Professional Practice*, coauthored with Simon Kuznets. In it he argued that state licensing procedures limited entry into the medical profession, thereby allowing doctors to charge higher fees than if competition were more open.

His landmark work of 1957, *A Theory of the Consumption Function*, took on the Keynesian view that individuals and households adjust their expenditures on consumption to reflect their current income. Friedman showed that, instead, people's annual consumption is a function of their expected lifetime earnings.

In *Capitalism and Freedom*, Friedman liberated the study of market economics from its ivory tower and brought it down to earth. He argued for, among other things, a volunteer army, freely floating exchange rates, abolition of licensing of doctors, a negative income tax, and education vouchers. (Friedman is a passionate foe of the military draft: he once stated that the abolition of the draft was the only issue on which he had personally lobbied Congress.) Although his book did not sell well, many of the young people who did read it were encouraged by it to study economics themselves. His ideas spread worldwide with *Free to Choose* (coauthored with his wife, Rose Friedman), the best-selling nonfiction book of 1980, written to accompany a TV series on the Public Broadcasting System. This book made Milton Friedman a household name.

Although much of his trail-blazing work was done on price theory—the theory that explains how prices are determined in individual markets—Friedman is popularly recognized for monetarism. Defying Keynes and most of the academic establishment of the time, Friedman presented evidence to resurrect the quantity theory of money—the idea that the price level is dependent upon the money supply. In *Studies in the Quantity Theory of Money*, published in 1956, Friedman stated that in the long run, increased monetary growth increases prices but has little or no effect on output. In the short run, he argued,

increases in the money supply cause employment and output to increase, and decreases in the money supply have the opposite effect.

Friedman's solution to the problems of inflation and short-run fluctuations in employment and real GNP was a so-called money supply rule. If the Federal Reserve board were required to increase the money supply at the same rate as real GNP increased, he argued, inflation would disappear. Friedman's monetarism came to the forefront when, in 1963, he and Anna Schwartz coauthored *Monetary History of the United States, 1867-1960*. In it they contend that the Great Depression was the result of ill-conceived monetary policies by the Federal Reserve. Upon receipt of the unpublished manuscript submitted by the authors, the Federal Reserve board responded internally with a lengthy critical review. Such was their agitation that the Fed governors discontinued their policy of releasing minutes from the board's meetings to the public. Additionally, they commissioned a counterhistory to be written (by Elmus R. Wicker) in the hope of detracting from *Monetary History*.

Although many economists disagree with Friedman's monetarist ideas, he has substantial influence on the profession. One measure of that influence is the change in the treatment of monetary policy given by MIT Keynesian Paul Samuelson in his best-selling textbook, *Economics*. In the 1948 edition Samuelson wrote dismissively that "few economists regard Federal Reserve monetary policy as a panacea for controlling the business cycle." But in 1967 Samuelson said that monetary policy had "an important influence" on total spending. The 1985 edition, coauthored with Yale's William Nordhaus, states, "Money is the most powerful and useful tool that macroeconomic policymakers have," adding that the Fed "is the most important factor" in making policy.

Throughout the sixties Keynesians—and mainstream economists generally—had believed that the government faced a stable long-run trade-off between unemployment and inflation—the so-called Phillips Curve. In this view the government could, by increasing the demand for goods and services, permanently reduce unemployment by accepting a higher inflation rate. But in the late sixties Friedman (and Columbia University's Edmund Phelps) challenged this view. Friedman argued that once people adjusted to the higher inflation rate, unemployment would creep back up. To keep unemployment permanently lower, he said, would require not just a higher, but a permanently accelerating inflation rate. (See Phillips curve.)

The stagflation of the seventies—rising inflation combined with rising unemployment—gave strong evidence for the Friedman-Phelps view and swayed most economists, including many Keynesians. Again, Samuelson's text is a barometer of the change in economists' thinking. The 1967 edition indicated that policymakers faced a trade-off between inflation and unemployment. The 1980 edition said there was less of a trade-off in the long run than in the short run. The 1985 edition says there is no long-run trade-off.

No other economist since Keynes has reshaped the way we think about and use economics as much as Milton Friedman. By his scope of topics and magnitude of ideas, Friedman has not only laid a cornerstone of contemporary economic thought but has also built an entire construction.

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