"Economic Myths and Public Opinion"

by Milton Friedman

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This morning I'm going to deliver a sermon. My theme comes from Josh Billings, the famous American humorist of the nineteenth century, who said, "The trouble with people ain't ignorance, it's what they know that ain't so." I propose to discuss five myths about American society which are very widely accepted, which have a great deal of influence on public attitudes and public opinions, and yet which in my opinion are wholly false.

The Myth of the 19th Century Robber Baron

The first myth might be called the robber baron myth. In your courses in history—ordinary political history, to a lesser extent even in courses on economic history—you will have learned that the nineteenth century in the United States was an era of rugged, unrestrained individualism in which heartless monopoly capitalists exploited the poor unmercifully, ground the helpless under their heels, and profited at the expense of the rest of the community. The rich got richer and the poor got poorer; Wall Street was set against the working man. You will have learned from the standard history book that the farmers in the Middle West were being ground between the millstones of falling prices for the products they sold and higher prices for the products they purchased. You will have learned that that was the reason for interest in the greenback political movement, the reason for the development of the populist sentiment in the Middle West and the South, the reason for that magnificent speech by William Jennings Bryan in 1896, when he asked whether mankind shall be crucified on a cross of gold.

That's the myth, and there is hardly any myth more deeply imbedded in people's attitudes. The myth was spread by the reformers, the muckrakers of the early twentieth century, by the intellectuals who contributed to the drastic change that has occurred in our attitude toward the market on the one hand and government on the other, which has in turn produced such a drastic change in the character of our society in the past forty or fifty years.

There is only one element of that myth that is correct. It was an era of rugged, unrestrained individualism. It was an era with the closest approximation to pure economic laissez-faire in American history. It was an era in which, except for the Civil War, spending by the federal government never exceeded about 3 percent of the national income, a sum which is derisory by today's standards when federal government spending is approaching 30 percent of the national income. It was an era in which there was, for most of it, no ICC, no FCC, no SEC, and you pick out any other three letters of the alphabet and it wasn't there either.

It was a period when about the only interference with what people could do, aside from the taxes that were being imposed to finance a small armed force, courts, legislatures, and the like, consisted of a protective tariff on imports. Laissez-faire economists objected then as now to such tariffs, but the level of the tariff was mild compared to the duties that were imposed later.

This situation did not develop, interestingly enough, out of any philosophical belief in laissez-faire. It developed much more simply. In the 1830s, state governments throughout the country proceeded to engage in what we would call socialist enterprises. They built canals, they set up commercial banks and extensive banking systems, they financed railroads, they put up industries. It was a great era of government enterprise. But in the recession, or panic, of 1837, many of these government enterprises went broke. They turned out to be inefficient in the same sense in which all government enterprises have been inefficient from that day to this. By contrast with the situation today, however, they were allowed to fail. It was this experience that set the United States on the road to laissez-faire.

While the nineteenth century was a period of rugged individualism, almost every other feature of the myth is false. Far from being a period in which the poor were being ground under the heels of the rich and exploited unmercifully, there is probably no other period in history, in this or any other country, in which the ordinary man had as large an increase in his standard of living as in the period between the Civil War and the First World War, when unrestrained individualism was most rugged. The evidence of this is to be found in the statistics that economists have constructed of what was happening to national income, but it is documented in a much more dramatic way by the numbers of people who came to the United States during that period. That was a time when we had completely unrestricted immigration, when anybody could come to these shores and the motto on the Statue of Liberty had some real meaning. This was a country of hope and of promise for immigrants and their children, and as many as a million immigrants a year came in 1906 and ’07 and ’08. By 1914, roughly a third of the population was foreign-born or the immediate descendants of foreign-born.

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

Of course, our condition is far better than theirs. In an absolute sense, their level of living was low. But we must compare their level of living, not to ours but to the level they left in Europe. We stand on their shoulders. We are able to live as well as we do because of their achievements, because of what happened during that period of the nineteenth century. I must say, it seems to me disgraceful for so many people to denigrate the experience of their parents, when that experience has made it possible for them to live in a free society at their present high level.

So much for economic development. What about the charge that the agricultural community was being ground down, that it was being exploited by the Wall Street bankers? That we needed to have a Greenback movement and a populist movement and a William Jennings Bryan?

Again, the contrary evidence is very simple and very clear. In the first place, if agriculture was being especially exploited, you would expect the number of people on farms to go down, but the number rose by leaps and bounds during the period. If agriculture was in a bad state and being exploited, you would expect the price of farmland to go down, but the price went up rapidly. The prices of farm products did go down. But they went down because the great fertile areas of the Middle West were being opened up and brought into production. Output was growing rapidly, the cost of producing crops was going down thanks to great technological innovation in the form of reapers and other agricultural machinery, and the cost of transportation was falling. The result was a great outpouring of production which produced a decline in the prices of farm products at the same time that it produced a very rapid rise in the incomes of farmers and induced many people to enter farming.

On a different aspect of this experience, was it a period of heartless monopoly capitalism? Quite the contrary, it was the period of the greatest private eleemosynary activity in the history of the United States. The period of unrestrained, rugged individualism was a period when the modern type of nonprofit community hospital was first established and developed. It was the period of the Carnegie Libraries and their spread through the philanthropy of Andrew Carnegie. It was the period when so many colleges were founded throughout the country. It was the period of the founding of the Society for Prevention of Cruelty to Animals, and the spread of foreign missions. There was no income tax, no deductibility of contributions, so what people spent on charity came out of their pocket and not, as now, largely out of taxes they would otherwise pay. And yet, in every aspect of private charitable activity, it was a boom period.

So the generally accepted historical picture of the nineteenth century is an extraordinary myth. Years ago I wrote a book with a collaborator on the monetary history of the United States, and in the course of writing it I read many of the general histories of the nineteenth century. As an economist, I was appalled by the level of ignorance of economic matters that was displayed in those history books, by the extent to which the historians were willing to take the cries and the claims of reformers and political agitators for reality.

Everybody, of course, always wants to improve his lot. Everybody would like to see the price of the things he sells go up, and the price of things he buys go down. But since what one man sells another man buys, that's hardly a feasible situation. We find the same inconsistency when people talk about inflation. What people mean by inflation is not the rise in their own wages but the rise in the prices other people are charging them. And that was the case in the nineteenth century. The people who were in the Greenback and the Populist movements were saying, "We want to do still better," but the historians have tended to take their exaggerated complaints for reality.

That's Myth Number One, a myth which has done enormous harm, in my opinion, by leading people not to recognize the true sources of the strength of this country and the true origins of our greatness.

The Myth of the Great Depression

The second myth is the Great Depression myth, the myth that that decade-long catastrophe—at the worst of which, in 1932–33, 25 percent of the labor force was unemployed—reflected the failure of private enterprise. Somehow, people believe that the Great Depression occurred because private enterprise could not organize society properly, that it was necessary for government to step in to save society, that the New Deal and all that followed was a necessary corrective to the mistakes and disasters produced by the deficiencies of private enterprise and unbridled competition.

The trouble with these beliefs is that they are completely wrong. The elementary truth is that the Great Depression was produced by government mismanagement. It was not produced by the failure of private enterprise, it was produced by the failure of government to perform a function which had been assigned to it. Since time immemorial, government has been granted the function, wisely or not, of controlling the monetary system. In our Constitution, government is given the power to coin money and determine the value thereof. We had the Great Depression because government failed in that task. In 1914, we had a supposedly great reform. But experience shows that not all reforms are improvements. In this case, the great "reform" was the establishment of the Federal Reserve System, a central banking system. It was established supposedly to prevent what were called banking panics.

The immediate occasion was the banking panic of 1907, when the Knickerbocker Trust Company went broke—like the Franklin National Bank, except that unlike the case of the Franklin National, tax money was not used to bail it out. It went broke, the public got worried about the stability of banks, there were runs on banks, and this led to what was called the banking panic in which the banks of the country suspended the convertibility of their deposits into currency. Banks continued to operate, but you could not walk into a bank, give it a check, and have it give you currency—at that time, gold or greenbacks or national bank notes. If you gave someone a check, it would be stamped, "payable only through the clearing house." That meant it could be deposited to his account at another bank but it would not be honored for currency unless he was a regular customer at the bank who had been accustomed to getting currency for payroll purposes. That was done to prevent banks from failing. After two or three months, confidence was restored in the banks, the suspension of convertibility was ended, and there were almost no bank failures. It was a very traumatic episode. In response to the panic of 1907, there was a Congressional investigation, and the Federal Reserve System went into operation in 1914 to prevent any such development in the future.

What was the actual course of events? From 1929 to 1933, far from preventing bank failures and bank collapse, the Federal Reserve System actually produced them.

On December 11, 1930, the Bank of United States failed. It was the biggest bank that had ever failed in the United States. Until then, the depression had been a more or less garden variety recession. But the failure of the Bank of United States set off runs on banks. According to its charter and its objective, the Federal Reserve System was supposed to step in and enable banks to meet demands of their customers by buying bonds on the open market or by providing currency through discounting assets of its member banks. It failed to perform this function. On the contrary, it allowed the runs to develop and banks to fail, until finally in March 1933 there was an absolutely unprecedented catastrophe in which all banks were closed for a week—

including the Federal Reserve Banks, which had been set up to prevent such an outcome but instead ended up producing by far the worst and the most disastrous panic in American history.

From 1929 to 1933, the quantity of money in the United States fell by one-third. For every one hundred dollars of currency or deposits that people owned in 1929, there were 67 dollars available in 1933. One-third of all the banks were permitted to fail. This was easily preventable, and I can say that not merely from hindsight. There were many people at the time who were urging on the Federal Reserve System a policy which would have prevented this outcome, including some at the Federal Reserve Bank in New York. All this is documented in the book mentioned earlier, *A Monetary History of the United States*.

The reason for the Great Depression myth is very simple. Private enterprise has no press agent. Government does. Every government agency will inform you that anything bad that happens is the result of forces outside its control. But anything good that happens—who do you suppose produced that? If it weren't so tragic, it would be amusing to read the annual reports of the Federal Reserve System from its inception. Every year of prosperity, the Federal Reserve report says, "Thanks to the wise and farsighted policy of the Federal Reserve, the United States had a good year." Every year of recession or depression, the Federal Reserve report reads, "Despite the best efforts of the Federal Reserve System, events beyond our control …." Even in 1932 and 1933, you have such statements in the Federal Reserve Board's annual report.

At any rate, far from being evidence of a defect in the private enterprise system, the Great Depression is evidence of the deficiency of governmental arrangements to manage the economy.

The Demand for Services Myth

Let me come to a third myth: the myth of a demand for government services. From the 1930s onward, there has been an enormous expansion in the scope of government. In 1929, just prior to the Great Depression, total government expenditures at all levels—federal, state, and local—were about 10 percent of national income. Today, the comparable figure is about 40 percent. Even that greatly understates government expenditures in a true economic sense, the control over expenditures by government.

To give a simple example: Anybody who buys a new automobile is required to spend something like $500 to $1,000 on items that he would not voluntarily choose, the safety and antipollution devices. Suppose that instead of government mandating that those be on every car, government had imposed a $1,000 tax on every new car and had used the proceeds to buy those attachments. We would then include that money as part of government spending, and it would raise the 40 percent figure. From an economic point of view, there is no difference between these two procedures. It might be good to have such devices on cars, or it might be bad, but that isn't the question. The question is what is the fraction of the national output whose use and allocation is determined through the political mechanism rather than through the decisions of individuals deciding separately how they want to spend their own money. And the answer is that it's well over 40 percent if we include these mandated expenditures.

In the process of going from 10 percent to well over 40 percent, the myth developed that these expansions in programs occurred in response to an overwhelming public demand, that the government has had to step in because the failure of private markets produced a grass roots demand that government do these things. This is a myth that could not be farther from the truth. Almost every expansion of governmental activity has had to be sold to the populace at large by misleading advertising that would make Madison Avenue blush. The community has had to be brought kicking and screaming to approve them.

Let me give you the greatest sacred cow of them all, Social Security. In the first place, it has nothing to do with social, and it has nothing to do with security. It's an utter misnomer; it's a program whereby you impose a very bad tax in order to provide very inequitable benefits. In the Orwellian language used to sell Social Security, what you and I would call taxes are called contributions. Is an involuntary payment a contribution? The tax you and your employer pay under Social Security is so labeled. If you buy an insurance policy or a retirement annuity or a pension, and you ultimately get your pension, that's a benefit, you paid for it. But if I get it from other taxpayers, ordinarily I would call it a subsidy. But under Social Security, subsidies are called benefits.

Much more fundamentally, the program was sold to the American people under essentially false pretenses, on the ground that the ordinary people were so shiftless, so little concerned with their own future that unless they were compelled by government to contribute to a fund and paid a pension afterward, they would all become charges of the state. The situation of the Great Depression, when people became charges of the state because of the state's mismanagement of money, was presented as typical. It was factually false that, the Great Depression aside, any significant number of people had become charges of the state because they had failed to provide for their own old age. Yet, that was the argument used to sell Social Security.

Again, maybe Social Security is a good thing. I'm not for the moment talking about that. I happen to think it is not. I think it's a terrible program, but maybe I'm wrong. I'm here concerned with the myth. Did Social Security reflect a grass roots demand for services? The answer is no. It was sold under false pretenses, and has since been expanded under similar false pretenses year after year by people who are in the business of selling government programs to the country.

Let me give a much simpler and more recent example, which I have already referred to: the safety and antipollution provisions for automobiles. Mr. Nader ran a crusade a few years ago that cars were unsafe and that we ought to have an all-wise government agency step in and protect us from ourselves, require us to have safety devices on the car, require us to fasten seat belts. Again, was there a grass roots demand for government to intrude into that area? Not a bit, it was a manufactured crusade which produced laws, the results of which most people don't like. Indeed, the absurd interlock system whereby you can't start your car unless you have first mastered the mechanics of the gremlins that the manufacturers built into your seat belts, led to such a national outrage that Congress repealed it. I doubt that people realize how extraordinary an episode that is. As a connoisseur of governmental intervention, I have tried to accumulate over the years the occasions on which an intervention has been eliminated. The list is very short. It includes postal savings, it includes Prohibition. It now includes the repeal of the provision for compulsory interlock. You will find it hard to add many to that list.

Consider another simple example. I was in Florida not long ago, just the week after Congress had passed a mass transit bill providing for billions of dollars to be spent in local communities on mass transit. There was a story in the local paper about a proposal to expand bus service, which had been put up to the local voters three years in a row in the form of approval of a bond issue. Three years in a row it had been turned down. Any student of democracy would say that that was pretty clear evidence that it was not something which the populace desired. But what happened? The newspaper story was, "Now that Washington has passed a mass transit bill, we'll be able to have that bus system," because the money will come from Washington. That surely was not a case where there was a grass roots demand.

The Free Lunch Myth

This leads to my next myth—the myth that government can spend money at nobody's expense. What was really involved in that last story was that somehow the local people do not pay out the money coming down from Washington, somebody else does. Of course, the truth is that the money makes a round trip between Florida and Washington, and there is a discount taken off for cash as it passes through Washington. Some of you may remember that wonderful description of government by the French economist, Frederic Bastiat, who said that government is that fiction whereby everybody believes that he can live at the expense of everybody else.

That is a widespread myth, that it is possible to spend money with nobody paying for it. You have everybody screaming that we ought to have new, bigger, more generous government programs. Where are we going to raise the money? Tax business. But business corporations can't pay any taxes. A corporate executive may sign the check, but where does he get the money? From his stockholders or from his customers or from his employees. Unlike the federal government, he doesn't have a printing press in his basement. So the only way he can pay money to the government is by imposing a burden on somebody. Government cannot spend money at nobody's expense, which in turn leads me to my final myth.

The Myth of Helping the Poor at the Expense of the Rich

Maybe government cannot spend money at nobody's expense, but, after all, we all know that government spends money to benefit the poor at the expense of the rich. Again, however, this is a myth. It is a myth which is promoted because everybody wants to do things for good purposes. We all are in favor of helping the poor—provided you and I are defined as the poor.

I was at the recent summit conference President Ford called in Washington. I was amused by the parade of special-interest spokesmen who came to the platform, and one after another said, "It is absolutely essential that we cut the government budget to beat inflation. I will tell you how to cut the government budget: spend more on me."

The elementary fact is that almost all government programs are either a complete waste and help nobody, or they benefit the middle and upper-middle classes at the expense of both the very poor and the very rich. That proposition could be the subject of a longer talk, so here I can only illustrate it.

Consider the case mentioned earlier—Social Security. That is a program widely regarded as helping the poor at the expense of the middle and upper income classes. The facts are, first, that the tax which finances Social Security is the most regressive tax in our system. It's a payroll tax on wages up to a maximum, the reverse of what is regarded as a graduated tax. The benefits are related hardly at all to the amount of taxes anybody has paid, and in any event are to a large extent inequitable. A man who has a million dollars of income a year from securities will receive his full Social Security benefit after age 65. But if between ages 65 and 72 he works and gets income from labor, then not only does he get no benefits if he earns more than a modest amount, but he also has to pay additional taxes on the wages.

Much more fundamentally, youngsters from poorer families go to work and start paying Social Security taxes at age 16 or 17. People who are going to be in the upper classes go to college and graduate school; they don't start paying Social Security taxes until 24 or 25 or 26. On the other side of the picture, it is a demographic fact that richer people live longer than poorer people, so they will receive Social Security benefits for more years. The poor fellow at the bottom has been suckered into paying taxes for more years in order to provide better-off people with benefits for more years—and that is what is known as a program of helping the poor at the expense of the rich.

I have been making this statement for many years, so I am delighted to note that a recent study by the Brookings Institution, which can hardly be regarded as biased on my side, has documented the charge in great detail. It has demonstrated beyond a shadow of doubt that on average the effect of Social Security is to redistribute income from lower income groups to middle income groups.

Take any other program you name, and you will find a similar distributional effect. There is only one program I know which probably gives more money to people in lower income classes than to the people who pay taxes, and that is one of the worst programs we have, namely, direct welfare. It's a bad program, not because it gives money to the poor, but because it produces poor people, because it encourages people to be on welfare instead of being on wages. I don't blame them. If you and I are fools enough to make it to their advantage to subsist on welfare rather than work, they would be foolish not to take advantage of it. Nonetheless, I have a great deal more sympathy for that program than for almost any other, because it is about the only one that really contributes to people in lower income classes rather than to the people who pay the taxes.

The great scandal of our times, in my opinion, is government expenditure on higher schooling. There is no other program so perverse in its distributional effects. In the great state of California, which has one of the most extensive public higher education systems in the country, over 50 percent of the students at the colleges and universities come from the top 25 percent of the families by income. Five percent come from the bottom 25 percent. When I want to be demagogic, I say that's a system under which the people in Watts send to college the children from Beverly Hills.

One could go on and on along this line. But I conclude by urging you to be more skeptical of some of these myths, to be skeptical of the myth of the robber baron, the myth of the Great Depression, the myth that there is an underlying demand for government services, the myth that government can spend money at nobody's expense, and the myth that government has benefited the poor at the expense of the rich. We have been moving in a direction in which we have an increasingly limited control over our own lives, and that movement has been nourished by a series of arguments which, quite simply, are untrue.

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