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# A Rational Future: More Markets, Less Government

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The ancient Greeks used to foretell the future by examining the entrails of sheep. This technique of forecasting, needless to say, proved wildly inaccurate, and from our current perspective it is easy to smile at the Greeks' superstitiousness and naivete.

Nevertheless, our age, with its vast knowledge and prodigious computers, has barely improved upon the Greeks' methods of forecasting. Predicting the future is still a task the wise approach humbly and the prudent not at all. As a curious man, however, I find it tempting to imagine our society in the coming years, and as a practical man, I find it essential to plan ahead.

I don't foresee any radical changes in the economic system of the United States. Instead, I expect the present free-market economy to evolve gradually, finding better ways to use its strengths and remedy its weaknesses. The system of free markets is viable enough to survive and, I believe, desirable enough to deserve to survive, because it makes efficient use of resources, both human and material. Under this system, consequently, people can have more of what they want than they could have in a politically controlled economy or in almost any feasible alternative economy. If people can control their destinies, and if they try to make the economic arrangements that can best provide the things they value, they will most likely choose some version of a free-market economy.

<u>Even your best trend won't tell you</u>. One way to envision the future--not the most satisfactory--is to examine current trends. Some observers believe, for instance, that this country will see a resurgence of the free market in some form. This is the trend, they insist. For support, they point to the deregulation of commercial airlines, an undisputed success, and to the increased freedom and competition in financial markets, which have provided investors and borrowers with many new accounts and services.

Outside of the United States, they point to Britain's new conservative government, which promises to stop socializing the country's industry and to allow the market to function.

Although these events are real enough, they may not reveal much about the future, for the trend toward free markets is opposed by a trend toward more government regulation and control. Some observers feel that this trend is really the vanguard of the future. They point to new rent control laws in California, passed despite all the problems rent controls have caused in New York City. They point to President Carter's multifarious energy program, a program in which the prices, the goods produced, the customers served, the development of new technology, the amount of profits, and many other decisions traditionally handled by the market mechanism--even the hours and days gas stations are open--could be placed under the jurisdiction of the government.

With contradictory trends existing side by side, the future can't be foreseen simply by identifying a trend, no matter how noteworthy a particular one may be. The reason for this is not just that several trends can exist simultaneously, though this is indeed a source of confusion. The reason, at root, is that without a good theory for guidance, no one can be certain how long or how far a trend will continue. A forecast based on a fleeting trend can be embarrassingly wrong. A demographer who forecast population growth based on the birth rates of the late 1950s would have imagined an American landscape as crowded as Hong Kong's. Although this sounds like an easily avoidable error, a good many prognosticators do virtually the same thing--they simply isolate a trend and assume that it will continue. Such a methodology may not be much better than that of the ancient Greeks.

Since trends can be misleading, economists, who are often called upon to predict the future, have developed techniques that can provide more accurate forecasts. They build models of the economy to tell them what will happen if specific policies are adopted or specific events occur. A model is a set of assumptions that expresses a theory of economic relationships and human behavior. One can construct a simple model by assuming that today's trends will be tomorrow's. But to make the best forecasts one needs a more sophisticated model that does not merely extrapolate current trends.

Building a model from assumptions. As an economist, I prefer to use a model that is sophisticated and explicit for making forecasts. The basic technique of model building--making some assumptions and deriving conclusions from them--can be applied to the problem of predicting the future of the market economy. This technique has long given good forecasts in microeconomics, it is beginning to give good ones in macroeconomics, and there is no reason why it can't help forecast how social institutions, like the role of government in the marketplace, will evolve. No economist would pretend that models provide perfect foresight--few would even claim they provide perfect hindsight. But this approach is the best I know of for predicting the future.

One must obviously be careful not to change assumptions in the middle of the analysis. If this sounds unarguably logical, good. Unfortunately, logical consistency is not a common practice either for predicting the future or for assessing economic policy. Many, many people who predict the future never reveal what their assumptions are, forcing one to read between the lines to determine if their predictions are consistent. And most economists, as I will explain later, use one set of assumptions for analyzing the behavior of firms and markets, and quite another for analyzing the effects of government policy. Strangely, in a discipline as technical and intellectual as economics, it is heretical to insist that the same assumptions should apply to all parts of the economy.

To build a model that can foretell the future of the market economy, one needs to start with some assumptions about how people behave. One theory of behavior that economists generally agree on is that people act in their own self-interest. This means, quite simply, that people strive to better their condition and to obtain the things they want. I find this a persuasive assumption. The alternatives--that people try to hurt themselves or just don't care--may contain a jot of satirical truth, but do not describe the way most people act.

From the basic principle of self-interest can be derived a host of inferences: People buy at the lowest price they can find, all other things being equal. People try to persuade government to enact legislation favoring their age group, region, or occupation. People learn from experience, if they can benefit from it in any way. People prefer more to less. That is, if they can have more of something they want--say, more leisure--without having to settle for less of anything else they want, then they will choose to have more. People decide how much to save, consume, and work based on their own preferences, their information about current opportunities, and their expectations about the future.

Self-interest is not always a matter of dollars and cents. Most of us, to one degree or another, value such intangibles as freedom, security, and personal reputation. To say that people pursue their own interests is not to say that we have forsaken all law and all conscience, that we are living in a modern jungle. If we feel better contributing to worthy causes, feeding the hungry, or helping a sick neighbor, then we are acting out of self-interest when we do these things. This is not to belittle such kindnesses. The point is that self-interest is not the same as selfishness. It includes all the things that people might want--and most people want love, friendship, and justice as much as they want material rewards.

Self-interest is not peculiar to the United States and other capitalist countries. It exists as well in feudal, socialist, and communist countries. The Soviet bureaucrat, the East German athlete, the African farmer, the Israeli teacher, the Chinese soldier--all try to get more of the things they value, even though their different political regimes channel their self-interest in different directions. The rules of the game differ, but the object remains remarkably constant.

Self-interest in a democracy. Since political structure can influence how people pursue their self-interest, one cannot build a forecasting model without making another assumption: that the United States will remain a democracy. This means, first, that people can exchange ideas freely in what amounts to an intellectual marketplace. If someone develops a cheaper way to produce steel, a fairer way to pay for governmental projects, or a better way to train executives, others can find out about them. This allows them to learn how to further their self-interest. This kind of freedom has long been a part of our country's traditions, and I don't believe we will give it up very easily.

There are, admittedly, some impediments to the free flow of information in this country, even today. Some are governmental. One can understand why the government wanted to censor instructions on how to build a hydrogen bomb, but one wonders why it won't let banks advertise that savers can pool their funds to buy high-yielding certificates of deposit.

The impediments to the free flow of information are not always governmental, however. For instance, when a representative of a television station called our Bank to ask that an economist appear on a broadcast, she said she didn't want a "knee-jerk free-market economist who doesn't care about people." I submit that this was a prejudicial remark. Although to her credit, she did allow our Director of Research to appear on the station, personal biases can prevent--and no doubt have prevented--useful ideas from being heard. Despite a few unfortunate impediments, though, new or unpopular ideas in this country are more available than not, and I will assume that this intellectual freedom will continue.

If the United States remains a democracy, people will not only be able to exchange ideas freely, but be essentially free to act. Again, this is part of our country's tradition and seems likely to continue. Most of the time, people are free to act in their own self-interest without the approval or interference of the government, as long as they don't defraud or coerce other people.

True, the government often takes on more ambitious projects than preventing fraud or coercion. It requires seat belts, licenses doctors, tests air, flouridates water, builds schools, sets speed limits, fights fires, sponsors research, and does thousands of other things that somebody feels are in the public interest. Such things do impair people's freedom to act. Nonetheless, I think it fair to make the assumption that people are essentially free to act. The people freely elected the government that imposed these restrictions on them, and they are free to reject it if they so choose.

All of these assumptions, of course, inevitably simplify the real world, and when the world differs from my assumptions, my predictions of the future will be less accurate. But all predictions of the future depend on some assumptions, whether stated or not and whether recognized or not, and the assumptions I have made seem sound.

The benefits of the market economy. If free individuals act in their own best interests, what economic arrangements will they choose? Clearly, those that provide them with the most benefits, and in virtually every case, a market economy provides the most. Those who heard this at grandfather's knee may think it went out of style with the buggy whip--and, all right, it may be out of style. But today's brightest economists are finding that it is nevertheless true, and their theoretical breakthroughs remedy many of the complaints about free markets that bothered the liberal economists of a generation ago. Although saying that a market economy is in the best interests of America sounds old-fashioned, it can be supported by some of the most radical economic research in decades.

To understand what a market economy is, it is first necessary to know what an economy does. All economies must solve some fundamental problems to decide three main things: what is produced, how it is produced, and for whom it is produced. In some societies, these decisions are made by tradition, as they were in India when it had a caste system. In other societies, such as the Soviet Union, these decisions are usurped by a dictator or delegated to representatives so that someone is responsible for comprehensive planning.

In societies with market economies, the decisions about what to produce, how, and for whom are made by individuals trying to better themselves. Individuals decide what jobs to take and what things to buy by using whatever information they have available. This sounds haphazard, but in fact, the checks and balances built into this system make it viable and efficient.

Prices: bringing order to the marketplace. The price system brings order to what might otherwise have been chaos, because prices are useful information. Given any set of prices, individuals make decisions in an effort to maximize their own welfare. Consumers, for example, make many decisions based on prices. To drive a car or eat a steak they must give up something else, and that something else, in the most immediate sense, is a sum of money equal to the price. The money, in turn, represents the skill, the time, or the capital needed to earn it. The trade-offs facing consumers, in other words, are conveniently indicated by prices.

Resource owners as well as consumers make decisions based on prices. In a capitalist society, the owners of resources, including workers who own their own labor, provide resources to the users who offer the highest price, all other things being equal. A higher price induces more people to provide resources. Expectations of a higher price in the future will induce them to withhold resources now and make them available later. People make decisions by considering their wants--their self-interest--and the prices of what they want.

Prices coordinate all these private decisions so that they reflect what society values. The U.S., for instance, produces more electric dishwashers than scullery maids partly because the machines cost so much less than a maid's salary. It is more efficient to employ, say, a thousand people to make and sell dishwashers than to have perhaps a hundred thousand maids washing dishes in individual kitchens. The prices reflect this, encouraging people to choose the more efficient alternative. Prices guide laborers in choosing where to work, too. They try to work at the best paying jobs, those where customers most want their skills or their product. Prices, in short, do what central planners try to do--but often more quickly.

Because the price system translates a great number of individual priorities into a single valuation for each item, it is a useful and responsive information system. Because of this, it is also an efficient economic system, as efficient as any that could be designed. Efficient, in the parlance of economists, means that given the total amount of resources--the workers, the managers, the raw materials, the technology, and so forth--there is no way to generate more output or more wealth. One economic system is more efficient than another if it can produce the same output with fewer resources.

No one, not even government experts, can come up with a more efficient system than the free market. The government can do many things--and should--but there is very little it can do to improve the performance of a free-market economy. The very best it can do is to figure out exactly what people want and need, what risks they want to assume, what pay they need to do certain jobs, and so forth, and then establish a government-run imitation of the market economy. The government, at best, can do what the market economy does all the time. And on a bad day it can do much worse.

When markets fail. Of course, in certain unusual cases, a system of free markets must be augmented with collective effort. Some commodities and services, for example, are public goods--goods that benefit everyone collectively but cannot in any practical way be divided up and sold to individuals. National defense and highways are generally seen as public goods. A strict market economy cannot provide these public goods because the benefits do not go proportionately to the people who pay for them. If Mrs. Jones hires a private army to patrol the border, Mr. Smith shares the benefits without paying a thing. If they both hire a few soldiers without some coordination, they could have two waring factions, benefiting neither of them. The clear solution is for the two of them to agree with the other residents to hire an army and split the costs in some manner. Collective effort, instead of individual effort in various markets, is necessary to provide these goods.

Another special case that calls for collective effort is the existence of externalities. Externalities are the benefits and problems that an owner passes on to other people without any payment. Painting one's house, for instance, gives one's neighbors a better view and perhaps raises their property values, but the homeowner pays for it and cannot charge the neighbors for it. Air pollution is another externality. A factory, within certain limits, can release undesirable effluents into the air, but does not have to pay people for their inconvenience. The market system by itself can't easily deal with such externalities, because they affect things no individual owns, like the view or the air. When the externalities are significant enough, the government does have a legitimate reason to respond, although it must choose its methods carefully.

A third special circumstance that calls for collective effort is the existence of monopolies. The competition of the free market usually keeps monopolies from forming, but when one does exist its products can be higher priced than they would have been if the firm had faced competition. This is why governments either break up monopolies, as happened with the old Aluminum Company of America, or regulate their prices, as happens with the telephone company.

All three cases of market failure--public goods, externalities, and monopolies--are rarer than many people think, and yet the government persistently intervenes in the market. Frequently, a market failure is not the motivation for its intervention. Rising or falling prices for a commodity, for instance, have often prompted government action. This is a pity. A falling price for steel or a rising price for gasoline might well indicate that the market is working, not failing.

Although government involvement may be necessary in the cases of public goods, externalities, monopolies, and maldistribution of wealth, one type of involvement is not as good as any other. All too frequently our representatives have taken the existence of market failures to be license for ignoring the market mechanism entirely. For example, outright bans on various types of pollution are established independent of the benefits and costs. This is clearly wasteful. Suppose the state of Minnesota wanted to cut air pollution in half. It could decree that by a certain date all polluters must cut their emissions by half, but this would ignore the costs of preventing pollution. It might cost as much to reduce pollution by one unit in factory A as it does to reduce it by one thousand units in factory B. Obviously, reducing pollution at factory B is preferable, a better deal.

The problem, perhaps, is that there is no well-known mechanism for legislating this. It is not feasible to have a different pollution standard for every factory. This is where the price system comes in. Minnesota could offer for sale permits for air pollution, something like fishing licenses. Each permit would allow the owner to emit a certain amount of pollution for a given period, and the state would sell only a limited number of permits, so that pollution would be reduced. The price of the permits could be determined by auctioning them off to the highest bidders. In this way, those companies that would have to spend the most to cut emissions would buy the permits, since this would be their cheapest alternative. The other companies would install antipollution devices--their cheapest alternative. Putting a price on pollution would thus result in more cost-effective means of reducing it.

Most of the time the government has no hope of improving upon the market; in the rare cases where it can improve upon it, it must take care not to ignore the market mechanism altogether, or else it will produce unnecessarily costly programs. Although government programs have produced some indisputable benefits, the same results could often have been obtained at a lower cost if the market economy hadn't been ignored.

A fair distribution of income. Even when the free-market system is working properly, the distribution of income may not meet our standards of fairness or security. This, however, is no reason to abandon the free-market system entirely. Our decisions about what to produce and how to produce it do not have to determine who receives it.

The optimal way to produce things and the optimal way to aid the poor must be considered as related but separate problems. For instance, when the poor cannot easily afford heating oil, we do not have to forsake the market and control the price of oil. If we left the price mechanism unfettered and simply gave poor people a certain amount of money to buy heating oil, we would have more oil because producers could get more money for it. In addition, the price system would still communicate a crucial fact: that there is, indeed, a short supply of oil and that we need to look for alternative fuels. A high oil price would encourage rich and poor alike to look for other fuels.

But, some people might object, if we just give the poor money, they might spend it not on heating oil, but on televisions. Televisions may not be the most socially worthwhile product in town, but when people buy them they are presumably buying what they want, given the real scarcity of all resources. In their own terms, they are better off--they have done what they want. Society, too, is better off because they have decided to buy less oil, leaving more available for those who value it more highly.

An important point, sometimes overlooked, is that all collective decisions--those dealing with market failures and those designed to redistribute income--force some people to purchase things they do not think they benefit from. Pacifists may object to paying anything for an army. People who like to drive on country roads may not want to pay as much as they are taxed for new highways. The poor may prefer to have dirtier air if it means they can better afford a car. In such cases, people are denied some portion of their freedom. A market economy, in contrast, leaves people free to make the choices that suit them best, as long as they can afford them. It provides not only the most output, but the most freedom.

Less is more. Since the free market generally provides the most of what people want, reducing the role of government in our economy would make people better off, except in cases of market failure, of course. Government involvement in markets is inefficient--that is, it provides less than the maximum possible from the resources it consumes--and not for any trivial reason. It is inefficient, first, because it uses resources to do what would have been done anyway. That is, if the government finds the most efficient way to price and distribute a product like gasoline, it is using our resources only to do something superfluous, because the market would have found the most efficient way without any governmental expenditures. Government involvement in functioning markets, in short, is inefficient because it is unnecessary. Second, it is inefficient because the government is rarely able to find the most efficient ways of doing things. When the government decides to get into the gasoline business, for example, it does not just duplicate what the market is doing, which would be inefficient enough. It creates new regulations and new roadblocks that further reduce efficiency. In short, its involvement is not only unnecessary but counterproductive.

In many individual markets where free competition could be expected to work, there is government involvement, often because special interest groups persuaded our representatives to intercede in their behalf in the marketplace. Usury laws, for instance, have been passed in many states to keep home mortgages affordable or to protect innocent borrowers. These laws are price ceilings, limiting the interest banks can charge for loans. Studies done at the Federal Reserve Bank of Minneapolis and elsewhere, however, have shown that interest rate ceilings fail to lower the cost of a loan. Sometimes, they dry up all the funds that had been available for lending because the people with money to invest put it someplace where they get a better return. Sometimes lenders find other ways to charge money for the loans, ultimately resulting in higher costs. Rarely do usury laws accomplish what they were intended to do.

Price floors have as many drawbacks as price ceilings. Minimum wage laws, for instance, contribute to the unemployment of unskilled laborers and are especially hard on minorities and teenagers. While floors and ceilings do benefit some groups, they are inefficient ways of doing so. If, as a society, we wish to alter the distribution of goods and services in favor of particular groups, such as indebted homeowners or skilled laborers, we can do it at a smaller cost by giving them cash gifts financed from tax revenues. We don't have to impede the free movement of prices, causing so many side effects.

This is not a controversial point in the economics profession. Economists are almost unanimous in their opposition to price ceilings, price floors, and other restrictions on competition. The reason they oppose price ceilings is that lowering a good's price by legal mandate exacerbates the scarcity that led originally to the high price. If gasoline is selling for a higher than normal price, this indicates that people want more gasoline or that suppliers have less to sell than usual. If the price can rise, fewer people will be demanding gasoline and more suppliers will be willing to find and sell it. A shortage thus can be avoided very easily with no government involvement. If the price is not allowed to rise, however, users have no additional incentive to conserve and suppliers have no additional incentive to provide.

In fact, price controls encourage relatively frivolous uses of gasoline. Suppose that two families both want ten gallons of gas at its current price. One family wants the gas to bring its corn harvest to town, the other to go waterskiing. At the current price, neither will change its demand for gas. As the price goes up, the family of water-skiers will find less expensive pleasures, and the family of farmers, valuing the gas more highly, will still be able to get enough to go to town. In no event would price controls on gas discourage waterskiing.

But what about the inequity, someone might say. What if the family of water-skiers is so rich that they would buy the gas at almost any price, letting the farmers be stuck at home. This may be unfair, but price controls would not solve the problem. If the price of gas is kept artificially low, the rich people will still buy a lot of gas and the farmers may still be stuck at home. If rationing were established, the rich could probably buy ration tickets or hire people to wait in line for them. And if rationing were strict enough to give everyone the same amount, the amount would have to be an average. Then, the rich who live in town might still have enough gas to go waterskiing while poor farmers still have too little to get to market. The only solution is to let the price rise. This will hurt the poor farmers, too, but it will hurt them and society less than any other approach, and after all, there is nothing the government can do about the real problem--that gas isn't as plentiful as it used to be. Price controls and rationing can't turn one gallon into two. When there is no market failure, government intervention tends to make things worse.

Those aggravating aggregates. What is true of individual markets is also true of the economy as a whole: government manipulation rarely helps. The government's efforts to manipulate aggregate economic variables like total employment, total income, and the average price level have failed repeatedly and are doomed to fail again.

Many economists would disagree with this statement. While they would agree that government intervention in individual markets is harmful unless it is addressing market failures, they would recommend that government manipulate these large aggregates. They hold this somewhat schizophrenic attitude because for many years the economics profession was unable to explain business cycles and unemployment with classical models of the free-market system, models that had people acting in their own best interests. Economists consequently took a shortcut. They tried to explain business cycles without developing a coherent theory; they treated the aggregates as if they had a life of their own and were not the result of individual behavior. In essence, their models were a set of relationships among aggregate variables. If inflation went up a few points, for instance, unemployment was supposed to come down a certain amount. These relationships were assumed to stay the same even in different periods and even when government policy changed.

Of course, since these models did not address the problem of people's individual welfare, they could not determine how to increase it. So, to establish a direction for policy, the economists had to impose value judgements from outside these models. Once they decided that low unemployment, a stable growth of GNP, and a stable price level looked worthwhile, they evaluated government policies by how well they could further these goals. It turned out that the policies that best fulfilled these goals in these questionable models required an active government. When these policies were taken seriously in the 1960s and 1970s, economic intervention became the rule rather than the exception.

The new economics. Two developments have led a growing number of economists to reject these government attempts to manipulate the economy. First, the relationships which were supposed to be stable have proved to be anything but that in recent years. The presumed trade-off between inflation and unemployment, for instance, was supposed to be an unalterable law. It is the whole reason for policies that intentionally create inflation to reduce unemployment, yet it has consistently produced wrong forecasts. It has missed the mark by embarrassing margins. Inflation sometimes jumped up four percentage points when it was supposed to drop two. The models adopted because earlier models didn't conform to the facts were themselves in glaring disagreement with the facts.

The second development that spelled doom for the models that ignored self-interest was a theoretical breakthrough. While some economists had simply cast aside classical models because they didn't explain business cycles and unemployment, others uncomfortable with the schism between microeconomic and macroeconomic theory tried to modify these models to fit the facts better.

Many of the early successes of this research came from Robert Lucas, now of the University of Chicago, and from Tom Sargent and Neil Wallace, both at the University of Minnesota and the Minneapolis Federal Reserve Bank. Their school of economic thought is usually called Rational Expectations. The name follows from the fact that people in their models are assumed to use all available information efficiently and to act in their own self-interest. They are thus rational. These economists, along with others in the field, have demonstrated that a market economy, inhabited by rational individuals, could indeed produce a trade-off between inflation and unemployment. But--and this is a crucial provision--the trade-off changes whenever government policy changes. Thus, government cannot exploit this trade-off--if it tries to cause inflation to reduce unemployment, it will get more of both inflation and unemployment.

Furthermore, the Rationalists have found that when individuals act in their best interests and process information efficiently, active governmental intervention makes individuals worse off. In fact, it makes them worse off even when its attempts at manipulating the economy are successful. Government can sometimes manipulate the economy so that GNP grows faster than it otherwise would, for example, but this does not make people better off. The manipulations trick people into working more than they otherwise would have, and tricking people into giving up their leisure does not give them what they really want. This goes back to the value judgements that the economists who built these models had to make--they assumed that rapid GNP growth was good, but they did not consider what sacrifices people would have to make to achieve this rapid growth. As it turns out, very rapid economic growth is so expensive in terms of foregone leisure that, given a choice, people on the whole would rather have their leisure.

An implication common to all Rational Expectations models is that neutral, stable policies are better than the on-again, off-again policies the government has followed to fight inflation or smooth out the business cycle. Rational Expectations theory implies that the best policies might include such steps as balancing the federal budget on average over the business cycle; avoiding drastic changes in federal expenditures and tax rates; controlling total government debt more closely; and making economic institutions like tax laws, welfare programs, and the regulation of banks more efficient.

<u>To market, to market</u>. Since people do act in their own best interests, they are motivated to learn how to improve their condition. As more people learn that free markets benefit them, they will instruct their representatives to reduce the government's involvement in working markets. In the future, then, there will probably be more rational

environmental regulations, fewer price supports, fewer interest rate ceilings, a less distorting tax structure, fewer minimum wage laws, and, in general, less government involvement in functioning markets. There will probably be fewer governmental efforts to manipulate unemployment and GNP, and more reliance on fixed, stable policies. Simultaneously, there will probably be greater efficiency, greater productivity, more freedom, more available goods and services, and, in general, a healthier economy. I'm not claiming that the streets will be paved with gold, only that the citizens of this country will try to improve their situation and will make some progress.

To be more specific, the future may see such changes in financial markets as:

- lifting Regulation Q, which limits the interest banks can pay on savings and checking accounts;
- allowing checking accounts at savings and loans, credit unions, and similar financial institutions;
- allowing more interstate banking and branch offices;
- eliminating most usury laws; and
- charging a competitive price for the services the Federal Reserve performs, like processing checks and shipping money to commercial banks.

I feel strongly that these changes are for the better. Banks and financial institutions would benefit from the new markets they could enter; consumers would benefit from the greater variety of services; borrowers would be able to find the funds they want; savers would be able to earn a fairer rate of interest. People, in sum, would get more of what they want.

A little bit of learning. To bring about this future most quickly, two kinds of institutional changes are needed. First, education, in the broadest sense of the term, is needed. Better economic education could start with better schooling. At the moment, high school students learn how politics and law can influence their society, but most don't learn even the rudiments of how these things affect economic well-being--and politics and law, more than ever, are determining how productive our economic system is. This is more than an advertisement for my favorite subject. This is a plea to recognize that our political or social goals can be met in various ways, some less expensive than others. There is no reason whatsoever to choose the more costly ways--they are not more moral, and they are certainly not more rational.

Another educational change needed to make people more aware of the price of government involvement in the market is to compute opportunity costs fully. Opportunity costs are not just the dollar costs, but the sum of all the things given up in order to realize a project. The opportunity cost of having a nationalized post office includes not only the subsidies that it receives, but the more limited service everyone must accept because there are no innovative competitors.

If opportunity costs were reckoned fully, government projects would almost certainly be less ambitious. Take the regulation of banks. Today, the Federal Reserve tells banks that the most interest they can pay on a daily account is 5 1/4 percent. This costs relatively little in enforcement or administration, but it is not a cheap program. At 5 1/4 percent, savers are losing real income because inflation is much higher than this percentage--this is one cost. In addition, many of them, rather than take this loss, look for better places to put their money--bonds, certificates of deposit, money market accounts, stamps, or rare coins, for instance. The time they spend doing this instead of something more productive is another cost. If just the main opportunity costs of government programs were calculated and published, people might begin to appreciate how efficiently the market works--and be a bit more suspicious of government intervention in legitimate markets.

A third necessary educational change is for proponents of markets to take different approaches than they have. I do not know what they need to do, but they have certainly failed until now. The politician who calls for price controls on haircuts to stop the dandruff crisis is seen as a selfless, kindhearted intellectual who sees big solutions to big problems, while the barber who objects is only a would-be robber baron. Few people would stop to ask whether there is a functioning market for haircuts, whether there is a connection between haircuts and dandruff, and whether a few more lint-free shoulders are worth the cost of a government war on dandruff.

Overcoming the resistance of favored groups. In addition to educational changes, there need to be other institutional changes if this future is to come quickly. One reason that some groups who pursue their own best interests resist a market economy is that our laws and regulations now favor them. Farmers, for instance, benefit from the price supports that the government maintains on various crops. If these price supports were removed, some farmers would be worse off until they could make the transition to other crops, more efficient techniques, or other types of work. Understandably, people in this situation are afraid of what would happen if the government stopped protecting them. Shoemakers don't want quotas on imported shoes lifted, steel manufacturers don't want tariffs on imported steel reduced, union members don't want nonmembers to be able to take over their jobs when they go on strike, although everyone else would save money if these things happened.

For such special interest groups to relinquish the favors of government, they need some guarantee that they will not suffer unduly while the transition to a more market-oriented economy takes place. This does not mean that no one will experience any loss of income. If no one did, no one would have the incentive to change jobs or look for more productive methods, and the economy would not improve. Any attempt to guarantee that no one will fail and that all incomes will rise proportionately is sure to eliminate the incentives crucial to an efficient market economy. But everyone can have the guarantee that the economy will be producing more goods and services and that everybody will have an opportunity to share this additional wealth.

One suggestion for making sure that no one starves or freezes during the transition to a less political economic system is the negative income tax. A negative income tax is a program for transferring wealth to the poor or to special interests based on income tax statements. Under this program, these people would receive a certain amount of money, probably on some graduated scale. There would be lots of hazards with such a plan. If the negative tax was set too high, it could discourage people from working and put a strain on the tax system and the whole economy. And if it was adopted without corresponding changes in other welfare programs, from price supports to food stamps, it could turn out to be an expensive step in the wrong direction. But somehow we need to make institutional changes to overcome the inertia of the present system; we need to remove the incentives that induce certain groups to fight against an efficient economy; we need to find a way to support the poor or subsidize favored groups without destroying the efficiency of the free market. If the negative income tax is not the best way to do this, we should be able to devise another way.

Ultimately, I am confident that we will find a way to overcome the obstacles and create a more vigorous market economy for the simple reason that doing so is in our best interests. If one were to take issue with my basic premise, that people act in their own self-interest, one might be able to come up with an alternative forecast. But one would have to make vastly different assumptions, assumptions that economists have rejected because they do not yield usable or accurate descriptions of economic behavior when consistently applied.

One might assume, for instance, that people won't see that government is imposing unnecessary costs on society. This is equivalent to saying that people can't learn from experience or research--and if economists really believed this, they would probably go into other lines of work. One might also assume that special interest groups will oppose ending the governmental practices that benefit them. No doubt some will, but they can succeed only if the U.S. is not a democracy, only if a minority can bully the majority into accepting something bad for the country as a whole. Again, this doesn't seem to be very plausible as a general rule, although it does happen on occasion. If it happened regularly, there would be no free market to defend or discuss--there would be in its place a political system designed to transfer wealth from the majority to the favored groups.

Assumptions other than the ones I have made seem to underestimate people or misread the political signs. They seem to imply that people are indifferent to pain, discomfort, and inconvenience, that they actively seek unpleasurable experiences, or that they are powerless to help themselves. These assumptions seem so implausible that I am persuaded again of the reasonableness of my assumptions and my forecast: People act in their own best interests; governmental involvement in markets and manipulation of the aggregates is not in their best interests; therefore, they will eventually reject unnecessary government intervention and develop a more market-oriented economy. This process may take a long time, but I await its arrival eagerly.