The Role of Incentive in Government and Private Behavior

Milton Friedman

Follow this and additional works at: https://digital.sandiego.edu/sdlr

Part of the Law Commons

Recommended Citation
Available at: https://digital.sandiego.edu/sdlr/vol29/iss1/2
The Role of Incentive in Government and Private Behavior

MILTON FRIEDMAN*

These remarks were delivered October 24, 1991 at the Sharon Siegan Memorial Lecture series at the University of San Diego and are published here with only minor revisions. The usual academic ornamentation by way of footnotes has been added to enable interested persons to find the sources referred to in the lecture.

No economist can stand up and speak about issues affecting private and governmental behavior without a reference to the remarkable events that have happened in Eastern Europe. We are seeing a major revolution, an event of earthshaking importance. This event has the potential for reshaping the world as no other major event of this century.

We in the United States have been observing what has happened over there, and we have been going around patting ourselves on the back and saying, “Our system has won and theirs has lost. We must be doing it right. They must be doing it wrong.” And so we are showing our generosity by sending them a stream of advisors to tell them how to convert their societies into models like ours.

At the same time, it is very hard to look around at the United States itself and not recognize that we are in a pretty bad state at home. Are we really in a position to tell them how to run their countries? There’s an old adage: “Physician, heal thyself.” Perhaps we need to learn from them and not the other way around.

What caused their problems? Nobody has any questions about that: it was too big, too intrusive, too pervasive and centralized a government. Tell me: what is causing our problems?

We are preaching to them what we do not practice and practicing

---

* Nobel Laureate Economist.
at home what we tell them not to practice. Our preaching is one thing; our practice is very different.

I believe a major issue facing the United States is our failure to learn from what we have observed in the world and to react to it in an appropriate way. This issue raises real problems for the United States.

I must confess that ten years ago, I was more optimistic about the long-term future of the United States than I am today. Ten years ago we seemed to be facing up to our problems. We no longer are.

If I may put the issue in a very broad perspective: more than fifty years ago, Oswald Spengler published a famous book entitled “Decline of the West.”1 His thesis was that all civilizations go through a cycle of rise and decline. He exemplified it by looking at the history of the Chinese, Egyptian, Greek, Roman, Persian, and various other civilizations. He argued that the West was suffering a similar fate. I did not believe it was true then and I do not believe that any such cycle, however common, is inevitable.

We are a free society and can control our own destiny. We do not have to follow a Marxist doctrine of preordained historical patterns. And yet, in describing the situation in the United States today, this thesis has an eerie ring of relevance.

On one side, we have an extremely affluent economy that is the envy of much of the rest of the world. But it is no longer growing as it was in the 1980s; it is no longer growing as it was during much of our history. Are we establishing the conditions for future growth or are we living on our capital?

On the other hand, taxes are rising, government spending is rising, government regulation is expanding, and our legislative bodies are deservedly at an all-time low in public respect.

We are spending more than ever on education, yet our schools are deteriorating. We are spending more than ever on law enforcement, yet crime is getting worse and our inner cities are becoming uninhabitable. We are spending more and more on medical care, yet dissatisfaction with the quality of medical care is going up, not down. Our cultural standards are collapsing.

What is it that is common in every one of these problems? Every one of them derives from the government.

Our schools are deteriorating. Why? Because they are run by the government. Law enforcement is deteriorating, crime is rising, prisons are overcrowded. Why? Because the government is trying to enforce laws that should not be on the books.

Obviously, the attempt to prohibit drugs is a major source of the

---

problem. We do not learn. We had the experience of Prohibition and we passed an amendment to end it. We need a similar amendment today in order to stop doing more harm than good.

The medical care system took around four percent of the national income in the decades before 1945. It is now taking twelve percent. There have been great advances in medicine. In fact, I would not be alive today if it were not for those advances. That is not in question. The question is: are we running our medical care system in such a way as to foster and facilitate those advances and make them more readily available to people; or are we running the system in a way that is going to make them less available?

Putting it that way raises the real problem: why is private enterprise a great success? Everybody around the world now recognizes it. The way to achieve economic prosperity is through private market enterprise.

Government enterprises everywhere are failures. Why should we be surprised at what is happening in this country? Why should we be better at socialism than the Russians? We are no smarter than they are.

Our educational system is failing because it is the largest socialist enterprise in the United States next to the military — and in a couple of years, it will no longer be next to the military because the military is going to go down, fortunately.

Why should private markets, private efforts conducted for the purpose of making profits, produce prosperity and well-being? As Adam Smith said 200-odd years ago, people who seek only to promote their own interests are led by an invisible hand to promote an interest which was no part of their intention.

Why is that so? Those people who supposedly are serving the public interest, supposedly using the power of the government to promote the good things — why are they failures?

One common answer is incentive: the incentive of profit is stronger and more effective than the incentive of public service.

In one sense, that is correct; in another sense, it is utterly wrong. The people who run our private enterprises fundamentally have the same incentives as the people who run our governmental enterprises. The people who run our private enterprises are seeking to promote their own interests. What are the people who are running our public enterprises seeking? Is there anybody who looked at the television a

week ago and watched the Senate Judiciary Committee in operation and said, “Oh, those are noble public servants.”

I do not blame the senators. They were seeking to promote their own interests; they were doing what they thought would be good for them.

The problem is not incentive in that sense. The problem is not that the people who run private enterprise are smarter, or more public-spirited or less public-spirited, or more ingenious than the people who run our governmental enterprises.

The people who staff our governmental agencies are a pretty fair sample of the population as a whole. They are mostly decent, able, public-spirited people no different from the people who are running our private enterprises.

In the same way, the Chinese who live on mainland China are no different from the Chinese in Taiwan and Hong Kong. And yet, on the one side, you have poverty and misery, and on the other side, you have great progress and development.

The people who live in former East Germany are not different from the people who live in former West Germany. It is the systems that are different. We have to see what it is about the systems that makes for the difference.

The explanation is simple. The actions that will serve the self-interest of the people engaged in private enterprise and market activities are very different from the actions that will serve the self-interest of the people who are engaged in governmental activities. They have very different bottom lines.

Consider the case of starting a new enterprise or a new venture. I do not doubt for a moment that people who propose new governmental ventures are just as intelligent and just as thoughtful about what might work and what might not work. They are just as understanding of the conditions that are required as are people who propose new ventures in private enterprise.

Suppose some of you here decide that you are going to start a new private venture. Most such ventures fail because most experiments are unsuccessful. The few successful ones somehow win out.

If you start a private venture and it fails, the situation is very clear. The only place you can go to get money to bail it out — unless you have great political influence — is to dig into your own pocket. Of course, you will try to use your political influence to make that unnecessary. But chances are, you will have to dig into your own pocket. And therefore, if the venture does not work out very well,

---

3. Hearings before the Senate Comm. on the Judiciary on the nomination of Clarence Thomas of Georgia for Associate Justice of the Supreme Court of the United States, 102nd Cong., 1st Sess. (1991) (allegation of sexual harassment against the nominee by Anita Hill was heard October 11, 12, and 13, 1991).
you have a strong incentive to recognize that and to close it down.

Suppose exactly the same venture starts under public, or governmental offices. [I started to say “public” but that is misusing the word. I think “public” is a much misused word. We speak of the University of San Diego where we are as a “private” institution. The University of California at San Diego, over in La Jolla, is said to be a “public” institution. But that is nonsense; both of them are public institutions. The difference is that one of them is a private institution and the other is a governmental institution. And so I try to substitute the word “governmental” for the word “public” in those cases. (Not when I am talking about public utilities but when I am talking about public universities and public schools.) The problem with our educational system is not public schools, it is governmental schools.]

So let us say the government starts a venture, a very promising venture; it looks like a good idea. Let us suppose that, like most new private ventures, it does not work. What is the bottom line for the people who started it? They have a very different situation.

The one thing that none of us like to do is admit we are wrong. The hardest thing in the world is to say, “I have made a mistake.” If you start a governmental enterprise and it does not work out, you do not have to admit you are wrong because you have someplace else to go for resources: you can go to the taxpayer. Moreover, you can do it in good conscience.

We all know that we do not make mistakes. We all know the reason our venture did not work is that we have not spent enough money on it; it has not been big enough. And so, in good conscience, we can try to persuade the public at large that we should spend some more money on it and that, if we only spend enough money on it, everything will be fine.

The result is that if a private enterprise is a failure, it closes down. If a government enterprise is a failure, it expands. That is not a hypothetical statement. Tell me: how many government activities can you name that have been closed down because they turned out to be failures?

In trying to answer that question for many years, I have found it very hard to come up with more than one or two or three. There is one I can come up with very quickly, and that was a postal savings program in the early 19th century. The liberals of that time thought it was desirable for the government to provide a way for individuals to save their money at the post office.

When they passed the law, the maximum interest rate you could
be paid was two percent. This was very popular during the Great Depression. But as interest rates rose after the Depression, not very many people wanted to leave their money at a two percent return. And so it was permitted to fail.

Two years ago, the government passed a bill to provide for extended medical care for the elderly. That aroused an uproar on the part of the people who were going to have to pay for it, and it was repealed. It is about the only case of that kind I can think of.

I ask you to stretch your imagination and tell me of the government mistakes and failures that have never been closed down. The nearest thing to permanence in this world is being a member of the federal legislature or an employee of a government agency, especially one that is not doing very well and needs more money.

Liberal pundits will tell you the source of our problems is that the public wants the goodies the government provides but does not want to pay for it. If only these selfish taxpayers were willing to dig deeper into their pockets and give more money to the government, everything would be fine. This is utter and complete nonsense. Every time the public has a chance to express its views clearly, it shows over and over again that it does not want what the government is providing.

In California, you recall that the voters passed Proposition 13 back in 1978. That proposition hardly indicated that government has what the public at large wants. Also, Proposition 4 attempted back in 1979 to set limits on government spending, but was unfortunately sabotaged by Bill Honig and his allies four years ago. Term limitation propositions are also sweeping the country.

Connecticut is imposing for the first time a state income tax, but not because the people voted for it. Whenever they had a chance to vote on it, they voted it down.

Tell me, do people really believe they are better off because of a government policy under which they have to pay three times the world price for sugar? Is there anybody in this room who, as a consumer, would voluntarily pay three times as much in order to use sugar grown in the United States from beets rather than sugar?

4. CAL. CONST. art. 13A (1978). Proposition 13 limited the tax that could be levied on property, and provided that the valuation for tax purposes could be reassessed only when the property changed hands.

5. CAL. CONST. art. 13B (limiting total annual state appropriations). This article, known as the “Gann Initiative,” was originally passed in 1979.

6. Proposition 98, passed by the voters on November 8, 1988, assured that overall K-14 education would receive a minimum guaranteed funding level outside the limits of the Gann Initiative. The base guaranteed funding level is the greater of: (1) the same percentage of K-14 General Fund revenue received in the 1986-87 fiscal year, or (2) an amount equal to the prior year General Fund revenue plus adjustments for enrollment and the cost of living.
grown in the Philippines from cane? It is absurd.

The problem is not that the government is spending too little; it is that the government is spending too much. Our schools are in trouble because we are spending too much on them. Our medical care is in difficulty because we are spending too much, not too little.

The end result is that the government has become a self-generating monstrosity. Abraham Lincoln talked about government of the people, by the people, and for the people. What we have now is government of the people, but it is by the bureaucrats for the bureaucrats.

And when I say “bureaucrats,” I am including the people we saw on the platform of the Judiciary Committee a week ago. The politicians have become bureaucrats. Being a legislator has become a civil service job — except it is a lot more attractive than most civil service jobs because it has all kinds of perks that civil servants do not get.

Again, let me emphasize this has not happened because the bureaucrats are bad people, but because we put them in a position where it is in their self-interest to make us poor. They are behaving like any other human being. You must not blame them. We deceive ourselves that we the people rule. We do not rule. We are headed the wrong way, in my opinion, because we have gradually developed governmental institutions under which the public has no voice.

We all recognize the role of special interests, and they are a real problem. We have agricultural supports because of special interests from the farmers. In the state of California, Los Angeles suffers from a water problem. We have lots of water, but we give it away below cost to farmers in order to produce crops which cannot be sold on the market and which the government buys as surplus. If we were only to say to the farmers, “Look, we will give you the water and you can sell it to anybody you want, you do not have to use it to grow crops,” there would be no water problem in the state of California.

Special interests like the farmers are a real problem, but not the major problem. I do not believe you can say we have a bad school system or a school system that is deteriorating because there are special interests who want the system to be that way. In a way, the people who are in it have become special interests. But the problem is not that those people are getting around the rest of us.

A recent article brought the real problem home to me — the real

problem is that the chief special interest is the government itself. The author, James Payne, examined the testimony of witnesses in fourteen different federal government hearings dealing with spending proposals. Payne found, and I quote, "1,014 witnesses appeared in favor of the spending proposals and only seven could be classified as opposed." In other words, pro-spending witnesses outnumbered anti-spending witnesses 145 to 1.

Of the 1,060 witnesses who appeared at the fourteen separate hearings, forty-seven percent were federal administrators and another ten percent were state and local officials. An additional six percent were congressmen themselves. So more than half of the people who testified did so not as individuals representing private interests, not as representatives elected by the people, but as governmental figures themselves. Payne concludes that Congressional views on spending programs are overwhelmingly shaped by government officials themselves.

I believe that is our real problem. What is true of spending proposals is true of all governmental ventures. The key question is: who devised these ventures? Let us take a few recent examples.

Last year, we passed something called the Clean Air Act. It will not contribute to clean air, but it will contribute to very high costs for the companies that have to abide by its regulations. The Act has introduced one good feature: namely, marketing the rights to issue pollution. But that is a very small virtue in a very bad bill.

Now, who devised the bill? Did the people who live up in Los Angeles where there is supposed to be very great smog go to Washington to devise that bill? No. The bill was devised by the bureaucrats in the Environmental Protection Agency and other governmental agencies. It was not devised by them because they asked the people what the people wanted. The bill was devised by them because it was in the bureaucrats' self-interest to have a program that they would have to enforce.

I do not blame them, do not misunderstand. The problem is not one of blame, the problem is one of understanding. And what we have to understand is that if we let government get bigger and bigger, if we let socialism expand, we are headed down the road to destruction.

Harkening back to "Decline of the West," as you look around this country, is there not an eerie resemblance? We see standards of civility declining. We see standards of culture declining.

We see some of our most honored traditions being breached. We see political correctness leading to restrictions on freedom of speech. We see attempts to prevent the use of drugs leading to violations of

The Role of Incentive

SAN DIEGO LAW REVIEW

civil and human liberties and to government appropriation of private property without due process.

We can go down the line in one area after another — the curse of drugs, the increase in teenage pregnancies — wherever you look, you see we are in a state of decline.

Our problem, as I said at the outset, is that we are unable to practice what we preach to Eastern Europe. We preach to them, "privatize, privatize, privatize," and all the time we socialize, socialize, socialize.

That is, in a nutshell, the character of our problem. And what can we do about it? The only real hope I see is term limitation. Get rid of the situation by which elected representatives become bureaucrats in a position where they can assure their own re-election.

We have fooled ourselves for years. We thought we could solve our problems by electing the right people. The problem is when you elect the right people, they become the wrong people. And that would be true of us; I am not blaming them. Anybody who thinks he or she would behave differently is wrong. When you got down there, you would be under the same pressures, and you would want to keep your job. And besides, you would know that the person who would replace you would be even worse than you.

So we are not going to solve our problems by electing the "right" people. We need a fundamental change in the character of the political system. We have been able to maintain a free society and have a strong private enterprise system for 150 to 200 years because the original restraints on the powers of government that were embodied in the original Constitution have been maintained.

As late as 1929, total government spending in the United States, at all levels, was about ten to twelve percent of the national income. Two-thirds of that was on the state and local level. Federal spending never exceeded three to four percent, and a lot of that was wasted, too. But the waste was trivial because we were a rich, rapidly growing country and we could stand it.

Federal, state, and local government spending today is forty-three percent of the national income. And that does not include the spending mandated on the people by government regulations. I estimate that the government controls the use of more than half of the total

resources of the country. It does not feel that way because that fifty percent is so unproductive.

The great achievements, the things that have enabled us to live on such a high level, have not come from resources controlled by the government, but from private enterprise and the private markets.

And so we have to do something, in my opinion, that will replace the kinds of restraints that worked for 150 years on the powers and role of government. Somehow or other, we have to roll government back to size. And maybe there is a better way of doing it than by trying to restore our legislators into private citizens who take a few years off to help out the government. But I do not know of a better way that has so far surfaced.

I realize term limitations carry all sorts of problems. But, at the moment, I see no better answer. So far, for the state of California, we need only look at the general results of propositions to realize we can have more confidence in the people directly than we can in the people elected to the legislature.

Studies show that the votes of the public at large on propositions are fiscally more responsible than the votes of legislators. Propositions are another route available to individual states, not only to achieve term limits, but also for many other purposes. Look at the effort in California to get a proposition on the ballot which would introduce a voucher system for schooling so that parents can choose where to send their children and get out of the disgraceful schooling system that we have.¹⁰

Let me close by saying, in a way, this is a very pessimistic judgment. And yet, in another sense, this is a great country. There is not another place in this world where you or I would rather be. It is up to us to take advantage of it. We are losing it — it is getting out of our hands. It is up to us to take it back.

Suggested Readings

Milton & Rose D. Friedman, Free to Choose: A Personal Statement (1980).
Frederich A. Hayek, The Road to Serfdom (1944).

¹⁰ The initiative, if passed, would allow students to attend any government school, regardless of where they live, beginning in fall 1993. Students wishing to attend a private school would receive a voucher equal to one-half of the per-child-spending in government schools.
W. ALLEN WALLIS, AN OVER-GOVERNED SOCIETY (1976).