Milton Friedman and the Chicago School of Economics

BY RICHARD M. EBELING

Milton Friedman, who passed away on November 16 at age 94, once commented that there is no such thing as different schools of economics; there is only good economics and bad economics. While he may have sincerely believed this, Friedman was nonetheless the twentieth century's most outstanding contributor to what has become known as the Chicago school of economics.

The University of Chicago's economics department was founded in 1892 with the appointment of J. Laurence Laughlin as the head professor. An uncompromising advocate of laissez faire and free trade, Laughlin may be said to have set the tone for much of the department for the next hundred years.

In the period between the two world wars the market-oriented approach of the department continued with the writings and teaching of such leading scholars as Frank H. Knight, Jacob Viner, and Henry Simons. While they cannot be said to have been as staunchly free market as Laughlin or many of the Chicago economists who followed them, they forcefully emphasized the superiority of competitive markets and the price system, and the inherent problems that arise from intrusive and discretionary governmental power.

The Chicago school blossomed into one of the most influential schools of thought after Friedman joined the economics faculty in 1946 and then was joined by his long-time friend George J. Stigler in 1958.

Friedman revolutionized macroeconomics, while Stigler helped to do the same in microeconomics. Friedman challenged the dominance of Keynesian economics in the postwar period, and Stigler's writings undermined many of the rationales for government regulation of business.

Their common method of analysis, which became a near hallmark of the Chicago school, was rigorous mathematical modeling combined with statistical research to demonstrate the empirical validity or falsity of an economic theory or policy prescription. They, their students, and a growing number of followers in the profession exposed as erroneous the Keynesian presumption that markets are inherently unstable and prone to monopoly.

Friedman and many of his Chicago colleagues shared a deep and determined allegiance to human liberty. Free markets, they explained, are the institutional guarantor of choice, opportunity, and limits on government control over people's lives. In *Capitalism and Freedom* (1962), for example, Friedman pointed out that when Hollywood actors, writers, and directors were blacklisted in the 1950s after being accused of communist affiliations, they were not doomed to starvation or imprisonment in the Gulag. Whether or not the blacklist was proper, those individuals could find alternative jobs in the marketplace because the government did not control or dominate the economy.

"The fundamental protection was the existence of a private-market economy in which they could earn a living," Friedman pointed out. Government denunciation did not mean literal destruction, as it did under the communism with which some of the blacklisted actually sympathized.

Friedman more generally expressed this idea in his widely acclaimed *Free to Choose* (1980):

> Economic freedom is an essential requisite for political freedom. By enabling people to cooperate with one another without coercion or central direction, it reduces the area over which political power is exercised. In addition, by dispersing power, the free market provides an offset to whatever concentration of political power may arise. The combination of economic and political power in the same hands is a sure recipe for tyranny.

Throughout the twentieth century the Chicago school's rival in the defense of the market order and the

Richard Ebeling (rebeling@fee.org) is the president of FEE.

free society has been the Austrian school, led by Ludwig von Mises and F. A. Hayek. The Austrians have also forcefully demonstrated the superiority of the free market and the hazards from all forms of socialist planning and government intervention. And they too have emphasized the uniqueness of the individual and the value of liberty.

But their starting points have been radically different in reaching their pro-market conclusions. In his famous essay on "The Methodology of Positive Economics" (1953), Friedman argued that the goal of science was successful quantitative prediction and that any hypothesis, no matter how unrealistic its assumptions, was good if it resulted in better predictions. Thus, as one critic pointed out, if a strong correlation was found between the anchovy catch off the coast of Peru and business-cycle fluctuations in the United States, this would be considered a good predictive theory, regardless of any real causality between these two measured events.

Causal Relationships

Austrians also believe that science should try to "predict," if by prediction we mean understanding the causal relationships in society and the market. But Austrians emphasize that the unique characteristic of social and market phenomena is man's purposefulness (an approach, by the way, that was also strongly defended by one of the older Chicago economists, Frank Knight).

Making sense of the market requires looking beneath statistical relationships. What is a consumer good or a capital good? When is a transaction "voluntary" and when is it "coerced"? What is a "competitive" market situation and when is a situation "monopolistic"? When is a "profit" earned and when is a "loss" suffered? What is it that entrepreneurs do and how do they and others in the market form expectations about the future?

These concepts and relationships are dependent on how individuals assign meanings to their own actions and to the objects and actions of other human beings around them. They are not reducible to measurable categories to which statistical methods of correlation may be applied.

In addition, the future is not as quantitatively predictable as too many Chicago economists have liked to believe. Indeed, one hypothesis for which Friedman was most famous in the 1960s and 1970s, that there is a relatively high correlation between some measurement of the money supply and national income, has become a hotly debated issue in macroeconomics again, as the definition of the money supply has become more uncertain and the correlations have become more unstable.

Furthermore, by insisting on a primarily statistical analysis of macroeconomic events, the data available have tended to be highly aggregated, with the focus on such things as output and employment as a whole and the general price level. This means the supply-and-demand details and the interconnections between various prices, which represent the actual causal relationships in the economy, are lost beneath the macro-aggregate surface.

Yet these microeconomic relationships, and how changes in the money supply influence and potentially distort them, have been the very essence of the alternative Austrian approach to understanding inflationary processes that end in recessions and depressions. Thus, for example, when Friedman looked at Federal Reserve policy in the 1920s and saw that the general price level had remained relatively stable, he concluded that Fed policy had done nothing wrong. The only error by the Fed was in the early 1930s, when it did not print more money to counteract the price deflation that was occurring at that time.

The Austrians, on the other hand, looking below the stable price level, concluded that Fed monetary policy had actually been highly "activist" and had generated imbalances between available savings and investment that finally resulted in the economic downturn of the 1930s. Whereas the Chicago economists of that time, and Friedman later, believed that the Fed should have "reflated" the price level through monetary expansion in these years, the Austrians reasoned that the distortions caused by the earlier inflation would only be made worse through any new round of inflation. Once the relative price and production relationships had been distorted by the earlier inflation, the only way to return to stability was through an adjustment of prices, wages, and production reflecting the new post-boom reality.

Nevertheless, in the face of Keynesian domination after 1945, Milton Friedman, with courage, determination, and intellectual integrity, went against the tide and, along with only a few others, succeeded in stopping the advance toward ever-increasing government control of society.