

PLANNING VERSUS THE PRICE MECHANISM*

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I must say that, after thinking it over a little I was a little uncertain, a little more than uncertain, a little unhappy with the particular wording of the topic. The reason is that I do not believe in the issue of planning versus the price mechanism. That is not the real issue. Planning is essential for the conduct of human life. The real issue is who shall do the planning and how. The real issue is should you have planning through the market or by means other than the market. In a country like Iran or other under developed countries, the development of an effective free market is also a type of planning. It requires planning by the government to provide the frame-work for a free market in the first instance, and in the second instance the definition of what is private property, what are the contracts that people may enter into, and the enforcement of those contracts are in the province of government. The preservation of personal freedom and safety, of law and order, is also a governmental function and is also essential for the effective operation of a free market. In the third instance the provision of a stable monetary framework is a governmental requirement, and is also a pre-condition for an effective free market.

So the question is, shall the government plan by providing an effective framework for a free market or shall it plan by trying to substitute for the free market the decisions of government bureaucrats, of civil servants, of particular individuals. That is the real issue, how to plan and not whether to plan.

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On a second level, there is another way to put the problem. People can differ either with respect to the objectives, the aims of planning, or they can differ with respect to the techniques or means of planning. In my opinion most of the differences in the conduct of underdeveloped countries do not arise from their objectives, they arise from a difference in techniques. I think almost all of us, both those who favour central planning, and those who, like myself, favour planning through the market, would say that our objective is to provide for as rapid an increase as possible in the standard of living of the ordinary people, of the individual citizens in a community. And the question we ask is how can we bring that about best. Can we bring it about by the techniques that have been so widely used in the post-war period; the techniques of centralized allocation of investment funds; centralized control of prices; centralized provision of subsidies through this that or another agency. Is that the way through which we can provide this help for improving the lot of the ordinary man? Or can we provide for this aim better by keeping government to the function of providing a framework for the free market, and letting individuals separately pursue their own interests, co-ordinating their activities through the market.

So far I have mentioned the difference between planning through the market and centralized planning, and next the difference between objectives and means. A third point I want to emphasize, and which I think is very important, is the invisible hand to which the chairman referred. This operates just as much when you have centralized planning as when you have a free market. The difference is that when you have a free market, the invisible hand works for the public good. When you have centralized planning, it generally works against the public good. But the invisible hand is present in both cases. Let me explain what I mean by that. If we take an individual who is conducting a business, we say he is doing it for his private interest or his private property. If we pay a man for a public service, if we make him the director of this, that or the other thing, we tend to act as if he was pursuing the public good. Not at all. He is still a human being and he is still pursuing his private interest. Only what is in his private interest becomes different. Let me illustrate this in a more extreme way. The manager of a factory in the U.S. and the manager

of a factory in the Soviet Union are both pursuing their private interests. One is doing it as an employee of a corporation, and the other is doing it as an employee of the government. As a result the incentives and sanctions are different. If the manager of the American factory makes a mistake he loses his job, if he does well he will make a lot of money. If he does very well, he make a great deal of money. The manager of a Soviet factory, if he does very badly, may lose his head! It is in his private interest to avoid doing that. If he does well, he may get a higher income, he may get an Order of Lenin or some other decoration; if he does very well he may get more power over other people. He too is part of a system of rewards and penalties which conditions his behaviour. But the rewards are different and the penalties are different. And as a result, he will behave in a different way. For example, if there is a project which has one chance in ten, let us say, of being a great success, and nine chances in ten of being a failure, the manager of the factory in the U.S. will reckon the money income he will get if it is a success, and the money income he will get if it is a failure. But if, on the whole, he will make more money on the one chance in ten (make ten times more money on the chance in ten) than he will lose in the nine chances in ten, he will go ahead.

In the Soviet Union in the same case the man is likely to calculate that if the nine chances in ten do not come out he will lose a lot, if the one chance in ten comes through he will gain very little, because his reward will not be proportionate to his success. As a result the first rule of every civil servant in the capitalist world, in the communist world, and in the in-between world is: do not do anything that is likely to be a failure, or rather is likely to be an obvious failure. If it is a concealed failure that is all right. But if it is going to be a dramatic, an obvious, a public failure, do not do it. Do not take any chances. Play safe.

And it is for this reason that you have a tendency, an understandable tendency, to behave in a way that will minimize the chance of getting into trouble. Of course, I am not blaming anyone, you and I would do the same if we were put in the same position with the same sanctions and rewards. In such a position we would have a strong private incentive to

follow rules, even if we do not believe in them or we think them to be foolish. We would be loath to take chances which would produce great returns but from which we would derive no benefit. All of us, as individuals, would behave in terms of our private interest. The great economist, Alfred Marshall, once said somewhere that if you want to understand how people behave, do not look at their noblest motives, look at their strongest motives. This is a very interesting and important point - if you want to find out how public servants, that is government employees, will behave, you should look at their strongest motives and these are the same as those of the rest of us: to promote our own interests.

Do not misunderstand me. Those interests may not be very narrow, indeed they may be very broad. The saint who takes up the life of monastic contemplation is also pursuing his interest as he sees it. To say that people pursue their interests does not mean that they pursue a narrow selfish interest: their interest may be broad, it may be narrow. For most people it is going to be narrow be it under a capitalist system, under a communist system, or under any other system. But for many people it will be broad. And this is why I say the invisible hand is just as much at work in a collectivist society, in a centrally planned society, as it is in a free enterprise market society. But in each it produces different results. It is leading people to behave in a way, in a collectivist society, in a centrally planned society, that is not in the interest of the public. We may remember Adam Smith's famous statement that people are led by an invisible hand to serve interests which are not part of their own initial concern. The quotation is not exact, but the general idea is that in pursuing their own interests people are led by an invisible hand to serve the public interest. Now he did not mean that governments do this - he was talking about a free market. Because in a free market each man bears the consequences of his own act. If I make a mistake I pay for it.

On the other hand if I am a government official and I make a mistake somebody else generally pays for it. If I do something splendid as a private individual, in a free market if I am Henry Ford and I produce millions of Fords that are of benefit to people all over the world, I, Henry Ford, get

some part, but not all, of the benefits. I may make a great deal of money, but the benefit to the world is far greater than the benefit to Henry Ford. But in the first place Henry Ford was induced to undertake the enterprise because he could benefit.

The great problem, I think, with central planning is that it is very very hard to do good with other people's money. The great problem I see in central planning is that it is a kind of system in which an attempt is being made to encourage people to go against their own nature. And it is very hard for them to do that. People by nature will tend to pursue their own interests and the interests of those close to them. And they will do this whether they are government employees or not.

Now, let me go on to much more specific examples and cases of the issue I have described. The chairman said that I mentioned the other day that I would like to know an example of a country in which the ordinary man as well as the wealthy man has had his well-being improved by central planning and that is the challenge I make to you. People have a strong tendency to answer Russia. But the example of Russia shows that a centralized society can always extract a large fraction of the income of the people for governmental purposes, and can thus use it for great monuments. The Pharoos of Egypt were able to extract a large fraction of the income of their people to build pyramids and the Soviet Union has been able to extract a large fraction of the income of its people to build a sputnik, to build dams, to build a strong military force. But that is a very very different thing from improving the condition of life of the ordinary people. If you look at the ordinary people in the Soviet Union, the great bulk, the mass of people, you will find that in many respects they have experienced very little improvement over the past fifty years, in terms of the amount of food they have to eat, in terms of the amount of clothes they have to wear, in terms of the houses in which they live.

The great achievement of the Soviet Union has come in the governmental section, not in the improvement of the conditions of life of the ordinary citizen. If you want to find out where the conditions of life of the ordinary

citizen have improved the most, you ought to go to places not like the Soviet Union, but rather to places like Western Europe, Britain, the U.S.; like Hong Kong, Japan, Malaya, places that have relied primarily on the market mechanism. But let me get away from this broad sweep and down to more detail.

Even if what you want to achieve is government monuments, it may be more efficient to do this through the price system than through central planning. Let me illustrate in concrete form. The example I have been talking a lot about this week, because it has impressed me so much in every under developed country that I have been to, is that they all believe that they are too poor to be able to afford second-hand automobiles. They have to have new automobiles. This is true of India, true of Korea, it is true of Venezuela, and it is true, I am discovering, of Iran. Now let us suppose that for whatever reason, good, bad or indifferent, a country like Iran decides that it wants to have a monument of a domestic automobile industry. I ask the question now as a technical economist, what is the most efficient way of achieving this?

The way India, Iran and Korea and other countries have tried to achieve it is by putting a high tariff or import restrictions, or import quotas, prohibiting the import of second-hand cars, and as a result making all automobiles whether produced at home or abroad incredibly expensive. Second-hand automobiles here, as you know, cost more as second-hand cars than they originally cost new, or than their new counter-parts can be purchased for today. Now that is a very expensive way of having a domestic automobile industry. Not only do you pay the high cost of producing the domestic automobile, but you also impose completely unnecessary costs on everybody. This is not just the cost to the people; you impose unnecessary costs on yourself by denying yourself the additional automobiles you could have by buying them cheaply abroad. If as a technician you come to me and say how can I use the price mechanism for that purpose, I would reply that it is very simple and much cheaper and better.

If you decide on a national objective: you want to have twenty-thousand automobiles a year produced inside Iran for the next ten years let us say. Well then, you

announce that you are willing to pay a capital sum to any automobile manufacturer who will agree to come to Iran and produce twenty-thousand automobiles a year for ten years. Maybe Fiat will come along and say if you give us a bonus of a million dollars, we will be willing to enter into this agreement. Maybe Rootes will come along and say 900,000 dollars. You take whichever offers you the lowest bid. And you give him the bonus, the capital sum, as a subsidy to compensate him for the losses he is going to incur by not producing those cars at home. In addition you leave the market for automobiles completely free. In that way you will have your locally produced cars, and you will also have a much more efficient system of transportation. You will have a much larger number of cars, you will have a greater use of automobiles and it will cost you much less in taxes and funds raised from the people.

That is a way to plan through the price mechanism. And I cannot see any argument at all in favour of doing it the way most countries do it. What conceivable justification is there for a country like Iran, given the number of cars it produces, to deny itself second-hand cars let us say from Germany, France and the United States. Let us take the Mercedes Benz I drove in, in Shiraz - the market price here for a five-year old Mercedes Benz is 50,000 tomans. If you bought the same second-hand car in Germany today you could probably buy it for a thousand dollars, or 8,000 tomans. What conceivable justification is there for using a Mercedes Benz - second-hand Mercedes Benz at that only in those activities which will yield enough income to justify paying 50,000 tomans for it? You could use them in a much wider range of activities if you paid only 8,000 tomans for them. The Benz we had was used as a tourist vehicle in Shiraz. If you had a sensible automobile policy so you could buy automobiles in the world market, the people who run this enterprise would be able to charge lower prices. You would be able to exploit tourism leaving aside the domestic values you would get. Here in a developing country you have ample manpower and a shortage of capital and there is hardly an industry in which there is a better way to use manpower than maintaining second-hand cars. A ten year old car in Iran is in far better shape than a ten year old car in the United States. And in the world of the division of labour the comparative advantage is for second-hand cars to be

supplied to Irān, to be repaired and to provide you not only with cheaper transportation but also to improve the level of mechanical skills of your people. In every respect that I can think it has its favourable effects. And yet because of a mistaken technique, namely, concentrating only on the domestic production of cars, you deny yourself those benefits.

Let me now shift to another example: What you pay for here for schools and universities. We might as well bring this up because already many people are angry with me so you might as well all be angry. It is certainly desirable that every country improves its human capital. More training is needed. Perhaps I should not say "more" because in my own country it may be that we are doing too much at the moment. But we do need the right amount of training and that means a considerable amount of schooling. The question is how to do this most efficiently. I will begin with the university level and work myself back down to the secondary level.

If you students are schooled, who gets the benefits? The answer is that you do, in the form of a higher income. Of course the nation benefits also just as the world benefitted when Henry Ford produced the Ford. But the fact that the world benefitted did not justify a government subsidy to Henry Ford. So the nation benefits when people are educated primarily because they themselves benefit. So the question is, who should be schooled? Those who benefit the most? How should that be decided? The answer is, by requiring those who benefit to pay for it. If you benefit why should the poor person who cannot go to school pay? What I am talking about is not only true in Irān, it is true in the United States and in every country of the world I know of. It is, in my opinion one of the greatest of scandals that we impose taxes on low-income people to provide a high income for a limited number of people.

In practice the people who go to the university generally come from middle or upper income classes but even if they come from poorer classes, they are going to be in the upper-income classes. I may take two poor people; two brothers in a low-income family, the one who goes to the university is likely to end up with a higher income than the one who does not. But why should the other one pay for it? And so,

the way to have higher education in a developed or an under-developed country is to have a system under which those who go to the university pay the cost. How? By having tuition that covers the cost. Of course if a person does not have the capital to begin with, we do not want to deny him the opportunity to get the schooling. Every young man and woman who has the capacity and the willingness should be able to pay for higher education. If they cannot pay for it now, it is highly desirable to have a private or governmental programme under which they can effectively borrow the money while they are going to school and pay it back later on out of the higher income that their university education will allow them to make.

There are various ways to set up such a scheme, involving making the amount of payment depend on the success of the individual. Thus, those for whom higher education does not in fact pay off are not required to pay back, and the return comes from those who are successful. But for my present purpose, I do not want to go into the details of it. I am only trying to contrast planning through the price mechanism and planning without the price mechanism.

What do we do when we plan without the price mechanism? We provide schooling either free or with a negligible tuition fee. What is the consequence? If you give something away for nothing, people value it at nothing. The consequence is that the people who go to university at somebody else's expense generally talk about education as being free. That is wrong, education is not free, it costs something, the question is who pays? What you mean when you say that education is free is that students who are going to university are riding on somebody else's back. They are being supported by persons who, for the most part, have a lower income. People have an incentive to go to university so long as it has some advantage for them. If you charge people for what their education costs, they will only go to university if it seems to them to be worth what they have to pay for it. So, if you use the price mechanism and charge people, they will waste their education much less.

That is one aspect of the matter, but there is a second one. If you are receiving your education free, you have no right to say anything about what happens in the

university. If you are an object of charity, pardon me if I use a strong term, but I use it to make you think about it, then the people who pay have the right to say what you should receive. He who pays the piper calls the tune. Students complain, and correctly, about not having enough power or control over their own education. They are right, but there is only one way they can get it. And that is by paying for it. As long as somebody else is paying for it, somebody else will have the say. If I am a teacher in such a university, that is in a free-tuition university, why should I pay any attention to students? My income does not depend on them. In fact it is a sign of the nobility of human character that teachers in such institutions pay as much attention to the students as they do.

On the other hand, if the students were paying tuition they would be in the position of customers who can control what they get. If you go to a store and you buy something and you do not like the service you are getting you go and take your choice somewhere else. And that provides you with a great deal of power over the seller. But if you get something for nothing and you do not like it, what do you do? Whom do you complain to? Do you complain through political channels? Do you throw stones through windows? That is one way of reacting. And maybe in cases in which the system is irrational where you have no effective means of reacting that is the only thing to do. But surely it would be a much better system if you are separately required to pay tuition with funds available, so you can ultimately, if possible, repay it out of your higher income. And then you will have the right to say something about your education, because if you did not like it you could take your custom away and go somewhere else. And you would certainly find that the teachers and administrators would find it very necessary to pay more attention to the demands and desires of students. Not because they are different people, but because the incentive, the reward, the penalties are now different.

Let me now come down to elementary and secondary education. Again what I am saying is as applicable in my own country as it is in yours. We have the same system in the U.S. as you have here, where you have public secondary schools. Students go to those secondary schools, and they pay

no fees. As a result, the government tells them, or somebody else tells them, what schools to go to. In our country this is decided mostly by location. If I live in a certain area, I go to school in that area. Let us suppose that you are required to shop in a certain store in your neighbourhood, that there is just one grocery store in your neighbourhood and it is against the law for you to go to any other store. Do you think you would get very good service in that grocery store? In the same way, if you are required to go to a particular school; you do not get very good service. Now let us suppose, that the government is prepared to subsidize secondary schooling with a certain sum of money. I don't know what it is in this country, 200 million tomans or something like that. And let us suppose that the cost per student per year is, let us say, 2,000 tomans. Then if you are spending 200 million tomans and it costs 2,000 tomans per person, that means you can afford to give 100,000 scholarships of 2,000 tomans per year per person. Suppose you say that the government is going to spend these 200 million tomans. But the way we are going to do it is by requiring the schools to charge a tuition fee of 2,000 tomans and then have the government select either on the basis of need or on the basis of ability, or both, 100,000 people to whom it is going to give scholarships and say to each student: you go to whatever school you most prefer, and wherever you go, you have the 2,000 toman scholarship with which you can pay for your schooling.

The total government expenditure on secondary schooling would be exactly the same. The number of students going to school would be the same, the subsidy would be the same but, quite suddenly, you would have an engine by which the quality of schools could be improved enormously. Now the students can be choosy; they can shop around. They can go to the best schools; and the schools would be required, would be forced by the circumstances to try to serve their students better. This is the way in which, through the market system, you can do your planning better.

Let us turn to the foreign exchange problem. The way not to have a foreign exchange problem is very easy - you simply have a free market exchange rate, float the exchange rate and let it be whatever it is necessary to clear the market. But let us suppose that for some reason, good, bad

or indifferent, the government says that as a matter of policy we are not going to have a floating exchange rate. We are going to keep the exchange rate at an official exchange rate. Then how should you handle it? You run into a foreign exchange problem eventually. The way in which under-developed countries have tended to handle such problems is by introducing import duties or by granting import licences. As I said earlier the difference between governmental systems and the private market is not only a question of private interests. In all of the under-developed countries I know anything about, the greatest source of wealth in the post World War II period has been governmental import permits. If you want to become a millionaire the quickest way to do so is to get to a country which has exchange control and import control, and persuade the government to give you an import license. In the U.S. you do it by persuading the government to give you a license for a TV station. That is an equally quick way and I may say I am equally opposed to it. But in an underdeveloped country import quotas have been the fastest ways of becoming rich, whether you are talking about India or Turkey or South America or whatever other country. I don't know about Iran.

When such countries have run into foreign exchange problems, they have generally handled it by saying that the government decides how much copper, how much steel, how much lead we shall import. And then we will give licences for that amount. In addition the government also says that we must try to reduce the demand for foreign exchange, and do this by providing subsidies for import substitutes. And there again the government says "we must try and gain more foreign exchange, so we will give subsidies to export industries." And the result is that the foreign exchange problem, created by a fixed rate of exchange, becomes a source of extending a particular kind of control which in its turn has become a source of enormous inefficiency in every country that has used it, as well as an enormous source of ill-gotten private gain. And indeed, once you start on that road, it is extremely hard to get off it. Why? Because you create all these private vested interests. Just as, once you start on the system of zero tuition in universities it is hard to get rid of it because you create a special interest among the students at the university who mistakenly believe that they are benefitting from the system, and who

form a pressure group against changing it.

Let us now go back to the foreign exchange problem and say what is the right way to solve it. Let us suppose that we accept that you are not going to change the exchange rate. The simplest way to handle it is to say that there is a certain total amount of foreign exchange; we will auction rights to use it. Let us say that Iran gets a certain number of dollars out of its oil revenues. You could say that every month we are going to have an auction, and we are going to auction off the rights to use 80 million dollars, or whatever the sum is. In that way the revenue would go to the government instead of the people to whom you give import licences, and in addition you would avoid all the unnecessary specific controls over how much lead, how much zinc etc. None of you have had the experience, I am sure, that I have had of looking through the books of regulations for import controls. I remember going through the texts which they had in India, through all the detailed regulations of how much of certain products can be imported. There were just incredible details of tens of thousands of items. A much more efficient thing to do is to say let the exchange go to those imports that people value the most. How shall we judge what they value the most? By how much they are willing to pay for it? That is better than by some arbitrary method of a public servant who, having no real basis for knowing, decides what to do.

Now, as you realize, I would even go further back. In the case of foreign exchange I would say you need never get into this problem. Let the exchange rate be free. In the case of the automobile industry I would go further and I would say let private individuals decide what to invest in. If automobiles are not privately profitable, there is no reason why poor people of a country who ride mules should pay taxes to subsidize automobiles.

I would go much further, and I want to close on this note, because I think it is important to understand what the real virtues of the private market are. The major problem under-developed countries say they face is capital investment, capital formation. And they all say the government must decide what industries to support and stimulate.

What is wrong with that? It may well be that in selecting in the first instance which industries to support, the government servants will be just as smart, just as wise, as a private individual who decides what industries to support. The government civil servants are intelligent, thoughtful, well-meaning people. They are going to try to pick the right things to do, just as private people will think. The crucial difference is not in the first stage. The fact is that an under-developed country is planning to change things. It is trying to produce a difference in the way things are going on. And that means that there is a great deal of uncertainty. There is no way of knowing in advance which will in fact prove the best industry and which will prove the worst. You can make informed guesses, but you must admit that the best of the guesses are subject to error. And so the important thing is to have some method of trial and error which will weed out the mistakes or reinforce the successes. Now, if a government engages in a large number of ventures, some will fail and some will succeed. But one thing you can be sure of is that they will all continue. The only thing that will happen if a government makes a mistake, is that larger subsidies will be given.

On the other hand, if private individuals invest their money, there is at least some chance that they will be permitted to fail. I say some chance, for this is the modern era and there is strong pressure on the government to bail out, to subsidize private industry as well. But there is at least some chance that the government can resist it. People think of the private enterprise system as the profit system. It is not; it is a profit and loss system. And the loss part of it in my opinion is more important than the profit part, because the loss part is the way you weed out your mistake. And the essential thing for a newly developing country is to have a system of trial and error which will enable you to weed out your mistakes. And that is why, I believe, that in so far as possible the under-developed countries will do far better if they permit investment to be determined by private profitability, under private auspices with the minimum of government intervention.

Now let me close by telling you a little story about planning that will summarize some of this. There is a very

fascinating book I once read entitled *How to Run a Bassoon Factory for Pleasure and Profit*. It is a take-off on these various business management books. And it starts with a definition of the difference between an unplanned and planned business. In an unplanned business things are always going wrong. Things are happening that you did not expect. You have to improvise. You have to make do, you have to muddle through your mistake. Now in a planned business it is very very different. In a planned business things are still going wrong. You still have to improvise, you still have to muddle through somehow. But you know just what would have happened if things had not gone wrong.

