

September 9, 2014 Chit Chat Club Essay

## **“Free to Choose” – But Will We Choose Wisely?**

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Over a year ago I considered giving my first Chit Chat Club essay on the ideas of Daniel Kahneman. His 2011 book, *Thinking, Fast and Slow*, remains in the top 5 of the *New York Times* Science Best Seller List.<sup>1</sup> Bill Nelson’s essay from last February convinced me I should explore further the relationship between Kahneman’s ideas on how we think and the problems facing our democracy, a “free society,” a large fraction of whose population now disapproves of both its Presidential and Congressional leadership. Bill Nelson’s point - that 72% of those in a public poll believe government has become too big – led me to think about the intellectual roots of the modern political right – particularly the Tea Party and the libertarians who advocate cutting back the activities of the federal government. I decided I would reread Milton Friedman’s two books, *Capitalism and Freedom* (1962) and *Free to Choose* (1980).

In this essay I will apply Hegelian dialectic to the ideas of these two Nobel Laureate economists:<sup>2</sup> thesis, antithesis, synthesis. Collegial discussion at the Chit Chat Club seems like an appropriate positive step. And I share my bibliography in hopes of stimulating my colleagues to go deeper than is possible in my allotted half hour.

I use two examples. The first is the financial crisis that built to a climax in 2007 and 2008, now referred to as the Great Recession, and not to be confused with the Great Depression of the 1930s. Timothy Geithner played a key role in the

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<sup>1</sup> As of today, September 9, 2014

<sup>2</sup> Named for German Philosopher Georg Wilhelm Friedrich Hegel (1770-1831)

[http://en.wikipedia.org/wiki/Georg\\_Wilhelm\\_Friedrich\\_Hegel](http://en.wikipedia.org/wiki/Georg_Wilhelm_Friedrich_Hegel);

[http://en.wikipedia.org/wiki/Dialectic#Hegelian\\_dialectic](http://en.wikipedia.org/wiki/Dialectic#Hegelian_dialectic). (Hegel did not use this term. It would be more appropriate to name dialectic for Johann Gottlieb Fichte.)

management of this crisis, first as a Governor of the New York Federal Reserve Bank during the George W. Bush Administration and then as Barack Obama's Secretary of the Treasury. His book, *Stress Test*, is a first-person account of his experience through this period, written in a way similar to how generals describe experiences of leadership in time of war. My first reaction to this book was fear of the instability that suddenly became apparent in our financial system – not just nationally, but worldwide. My second reaction was admiration for Geithner and a small group of others, who met this crisis working intensely under great stress, improvising policy as events unfolded. They had a good understanding of the role of banks and bank-like institutions that are not banks, but might be called “shadow banks.” This small group persuaded the President and Congress to take extraordinary steps that seem to have made the Great Recession much less severe than the Great Depression.

This crisis illustrates the importance of (1) public perceptions and the quick, pattern-recognition type of thinking that Kahneman calls System 1, and (2) the government's role in managing the currency, as described in Friedman's books.

My second example is medical care. There has been much partisan debate about “Obamacare” (The Patient Protection and Affordable Care Act) signed into law in 2010. This legislation has so far survived numerous attempts to overturn it. Many people dislike the “system” of medical care in the US and would like to see it improved.

I include two new books I have read in preparation for this essay: *The Fourth Revolution*, by the editors of my favorite news magazine, *The Economist*; and *The Rule of Nobody*, by Philip Howard, author of a previous book I thought excellent, *The Death of Common Sense*. I briefly mention two more: *Catastrophic Care*, by a business man, on reforming US medical care, and *Doctored*, by a disillusioned physician. (This one is added, based on the book review in today's *New York Times*.)

My main theme is the importance of *individual* decision making, as opposed to a view of *social decision making as a process of making rules to assure good behavior and good outcomes*. Subthemes include (1) the potential for prices and

incentives to influence behavior, and (2) the need to avoid concentrations of political and economic power, inside and outside of government, and, especially, the combination of both. We might call such concentrations “special interests.” Special interests threaten our freedom of choice, a point on which I think Friedman, Kahneman, Bill Nelson, and many others would agree.

Our democratic society is overburdened with rules, often created and maintained by special interests. These rules may reflect good intentions, but collectively they have become far too extensive. Many of us pay lawyers and accountants to help us keep track of the rules. The rules often are outmoded, counter-productive, or both. We need more leadership and wise decision making, rather than decision making determined by “following the rules.”

I empathize with those advocating less government. But I think in their frustration with bureaucracy and its multitude of rules, in government and in other large organizations, they fail to understand why good government is essential to our society’s well-being. And good decision making seems like a key enabler for good government, as well as for success outside of government.

Let me now provide some background on Daniel Kahneman and Milton Friedman and their ideas.

Daniel Kahneman won the Nobel Prize in economics in 2002, which is a remarkable accomplishment for a scholar who considers himself a psychologist and not an economist. He was born in Israel in 1934, grew up in Paris and lived there through Nazi occupation, then went to Israel where he received an undergraduate degree in mathematics and psychology. He received his Ph.D. in psychology from UC Berkeley. In late 1960s he began collaborating with Amos Tversky, who was part time at Stanford. This collaboration lasted until Tversky’s death in 1996.

Kahneman, Tversky and a young economist named Richard Thaler created *behavioral economics*. Its key idea challenges the standard assumption in economics, that people use a rational process for deciding what is best, in making

their choices. People often depart from rational behavior, in ways that follow predictable patterns. (Bill Nelson described these departures in his February talk.)

Thaler's initial observations were of his University of Chicago boss, a professor of economics and dedicated oenophile. This professor's behavior pattern in buying and selling bottles of fine wine clearly departed from the standard economic theory. The pattern was consistent with the research findings by Kahneman and Tversky.<sup>3</sup>

Kahneman's book, *Thinking, Fast and Slow*, describes decades of research in cognitive psychology and behavioral economics. Most of us, much of the time, depart from a rational reasoning process. We use System 1 thinking –“fast” in the book title. Our brains are very good at recognizing patterns from our previous experience. Early humans survived by reacting appropriately to perceived opportunities and threats. Logical reasoning came along much later. It is what Kahneman calls System 2 thinking -“slow,” and more effort needed. We often do not use System 2 when we should, either because of laziness, or hubris that we are good intuitive decision makers. System 1 thinking may not be good enough when facing choices with considerable complexity and uncertain outcomes that will have a big impact.

Therefore, “freedom to choose” can give inferior results if you do not think carefully and systematically using System 2. Intuition, System 1 alone, may not lead you to wise choices, especially in areas where you lack extensive experience. Reading Kahneman will teach you about the patterns in your System 1 mistakes.

Making wise choices using System 2 requires taking time to ponder. Examine the details, be comprehensive and consider long-term as well as immediate consequences. Seek guidance from those with more information and experience than you may have in making choices of the kind that you face.

An example is developing a plan for a new business. Consider the process for making a good one, as opposed to a poor one. Intuition may indicate a high

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<sup>3</sup>*Thinking, Fast and Slow*, pp. 292-3.

potential for success. Analysis often uncovers weaknesses that can result in failure.

Advertising and marketing took on added importance as we became a society of people doing business, not in small communities, but over large distances, communicating through radio, television, and then, the internet. Viewed positively, advertising helps people find what they want. But skilful persuaders can mislead, and they take full advantage of mistake patterns in System 1 thinking. Those who are misled we call “suckers.” A lesson from Kahneman is that it is all too easy to be a sucker if you are not well informed and you make your choices quickly and by intuition.

Why did I choose Milton Friedman as the antithesis of Kahneman? *The Economist*<sup>4</sup> called him “the most influential economist of the second half of the 20<sup>th</sup> century.” He is best known for his writings on the subject of “economic freedom.” This term is used widely in discussing the ideas of the political Right. As an example, a recent *New York Times*<sup>5</sup> article on brothers Charles and David Koch states: “Koch-backed organizations have largely steered clear of the bitter battles between establishment Republicans and Tea Party Conservatives, instead encouraging Republicans to emphasize economic freedom ... “.

Friedman became the intellectual spokesman for the political movement led in the United States by Ronald Reagan and in Britain by Margaret Thatcher. This movement sought to curb the growing role of the state and undo decades of expanding socialism and state programs, replacing these with “economic freedom” – social progress through the efforts of individual and corporate entrepreneurs, not government.

Milton Friedman was born in 1912 in Brooklyn. He studied mathematics as well as economics, finishing his bachelor’s degree at the height of the Great Depression in 1932. He worked in the Roosevelt Administration in the late 1930s and again during World War II. At that time he regarded positively federal job creation

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<sup>4</sup> November 23, 2006

<sup>5</sup> August 31, 2014

programs like the WPA,<sup>6</sup> and he helped to invent the federal payroll tax withholding system. After obtaining his Ph.D. in 1945 he took a faculty position at the University of Chicago. His research, especially that on monetary policy, led to his becoming the sole recipient of the Nobel Prize for economics thirty years later. About that time he came to California, to the Hoover Institute at Stanford University.

Friedman wrote eloquently on the function of markets for facilitating a decentralized process of bringing materials and labor together to make products. Markets allow rapid communication and revision of supply-demand relationships through prices as a means of signaling among many different entrepreneurs, each acting freely in self interest. The result is an efficient, well-coordinated system.

Friedman stressed the benefits of economic freedom, but also stressed the limits. Madmen and children are his examples of those who should not be expected to make good choices. In what I have read of Friedman he doesn't develop ideas on how madmen and children should be managed, as exceptions to "Free to Choose." We all start off as children. We need to learn to choose wisely, and such learning is a continuing process through our lives.

Another limit is that many markets are not free: a few parties are often able to control supply and therefore prices. This is not always done by capitalist owners – "monopolists" - it also can be the workers, such as in medieval guilds or labor unions.

While one might get the impression that Friedman had a low opinion of government, that impression would be incorrect. Friedman viewed government as essential to a democratic society, but capable of a negative impact:

...the great threat to freedom is the concentration of power. Government is necessary to preserve our freedom, it is an instrument through which we can exercise our freedom; yet by concentrating power in political hands, it

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<sup>6</sup> Works Progress Administration, established in 1935, renamed in 1938, and dissolved in 1943.

is a threat to freedom. Even though the men who wield this power initially be of good will and even though they be not corrupted by the power they exercise, the power will both attract and form men of a different stamp.<sup>7</sup>

Friedman's books give many examples of how government regulations intended to assure competence, deter fraud, or provide safety get captured by special interests, making goods and services more expensive because market freedom has been reduced. Restriction of access to medical school is one of Friedman's examples of a monopolistic practice, to which I shall return in my second example.

According to Friedman, government has two key roles on which society must depend. The first is protection against enemies, both foreign and domestic. Power that can be used to do evil must be restrained, and governments must have the military and policing power to enforce such restraint. The second key role, for national government, is managing the currency – the medium of exchange for goods and services in commerce. Friedman's great economic research accomplishment lies in his studies of the money supply and how mismanagement of the money supply can lead to depressions such as that of 1929 - World War II, the Great Depression. Friedman agreed with the theory developed by John Maynard Keynes about fiscal and monetary stimulation. But in practice, the government can be slow and ineffective in stimulating the economy when needed, and also in removing such costly stimulation when no longer needed. Friedman's two books say relatively little about how government should assure safety in the practices of large financial institutions.

Now I turn to Example One: The Great Recession. What can we learn from Kahneman and Friedman?

Societies, going far back into human history, have needed a currency for exchange that is perceived as stable and trustworthy. The currency enables agreements for

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<sup>7</sup> *Capitalism and Freedom*, p. 2. The Austrian economist Friedrich Hayek held similar views. See *The Fourth Revolution*, page 85-86, with its reference to the review in *The Economist* of Hayek's book, *The Road to Serfdom*.

trade across distances, and investments over time. If suddenly this currency becomes unavailable – (i.e., your bank will not give you money from your account or from your line of credit) - the system breaks down and commerce goes into precipitous decline. It has happened many times in US and world history.<sup>8</sup> The root cause is not well understood, even by many economists. Friedman gets it right; it is a crisis in confidence: People fear the loss of their assets and their opportunities. They run to get money from the bank before the bank fails. This behavior *causes* banks to fail. It is in the nature of banks.

Banks take money from their depositors, who often agree to leave it in a bank only a short time. The banks lend this money out at a higher interest rate than they pay to the depositors. The loans often support investment over a lengthy period, such as for a house or equipment needed by a business. The bank keeps only a small fraction of the money deposited on hand to meet requests for withdrawals.

Depositors do not want their money to lose value. And businesses that require loans can find that loss of access to credit forces them to curtail their business activity.

Why was the Great Depression so bad, and recovery so slow? In Friedman's judgment, the key event was not the stock market crash in 1929, but rather the failure of banking authorities to rescue a specific bank in New York City, Bank of the United States, a relatively small bank owned and managed by Jews and serving the Jewish community.<sup>9</sup> In December 1930 a plan to rescue this bank fell through, panic ensued among depositors trying to retrieve their money, and a cascade of bank failures followed. Roughly 10,000 of the 25,000 US commercial banks operating in mid-1929 disappeared through failure, merger, or liquidation. Unemployment went to 25% as the US economy collapsed. Impacts in some other countries were even worse.

Timothy Geithner's book *Stress Test* describes from an insider's perspective the events at the end of the George W. Bush Administration and the beginning of the

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<sup>8</sup> *Manias, Panics, and Crashes.*

<sup>9</sup> *Free to Choose*, pp. 80-82.

Obama Administration, as financial institutions went into crisis. Geithner observes, “ ... the fall of Lehman was a serious blow, shattering confidence around the world. It was the most destabilizing financial event since the bank runs of the Depression.”<sup>10</sup> But, unlike 1930, this destabilizing event was recognized as a crisis in confidence. The potential for panic could be overcome by injecting massive resources from the federal government to limit the prospect of bank runs and cascading failures of banks and shadow banks.

I’m not knowledgeable enough on the details to assert that Geithner and his colleagues did everything right, but I think they understood the nature of the problem and avoided having a bad situation become much worse.

Many politicians and much of the public hold contrary opinions on the actions that were taken. Why did Wall Street’s bad bankers and insurance executives get federal bailouts and huge bonuses while Main Street lost jobs and customers? Was this crisis not the result of stupid and restrictive government regulation? I think Geithner, Friedman, and many other scholars would respond that there was a failure by government authorities to anticipate and limit what turned out to be unsafe financial practices. Better performance by government is needed in its key role of managing the nation’s currency, which is intrinsically tied to its banking system. But the 2008 crisis turned out much better than in 1930. The actions recommended by Geithner and his colleagues, and taken by Presidents of both parties and by Congress, succeeded in stabilizing the financial system and restoring confidence. The economic damage was moderate rather than really severe.

It seemed like a close call. After reading Geithner’s book I worry that the world financial system is still relatively unstable: the US has too much debt and pension obligations, with too little attention on managing needed infrastructure investment. The situation in Europe and some other countries may be worse

This first example highlights (1) the importance of perception leading to widespread panic, relating to Kahneman System 1 fast thinking, and lack of

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<sup>10</sup> *Stress Test*, p. 212.

analytical System 2 thinking indicating a crisis was coming, and (2) Friedman's admonition for the federal government to manage the currency and the banking system. Those calling for less government might take note. There was too much freedom in the market, and too many people were persuaded to be "suckers".

Now I turn to Example Two, and Friedman's observations, in books written 50 and 35 years ago, about medical practice in the US, as an example of where free market principles are not being followed. I am not here taking a position for or against the ideas Friedman expresses: that restriction on the number of medical schools is a bad idea, because it raises medical costs at the expense of patients,<sup>11</sup> or that it is a good idea, because it keeps people from practicing medicine who lack the mental capability and proper training. I think it is widely believed that the US medical system is a mess, with high costs and many instances of poor performance.<sup>12</sup> Yet in many areas of biomedical research, the US is regarded as the world's best. What insights do we get from Friedman's writings? And are there insights from Kahneman?

What I found remarkable about Friedman's writings on medical care is many of the innovations he advocated have happened, or are happening now. Fee-for-service medicine by separate specialists is giving way to clinics and group practices, where teams of physicians of different specialties work together. The role of non-physicians – paramedics, technicians, nurses, and patient advisors – is expanding, so that many tasks formerly done by physicians are now done by non-physicians, saving money and freeing physicians for tasks where their training and experience is more essential. These changes indicate more freedom, more flexibility, and more competition in how to reduce costs.

A recent forecast by the Congressional Budget Office indicates that cost increases projected for Medicare are becoming less.<sup>13</sup> Improvements in technology and the way medical services are organized are reducing the cost of individual patient care and improving medical outcomes. But increased longevity implies large increases over time in overall federal outlays for Medicare.

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<sup>11</sup> *Free to Choose*, Chapter 8, especially pages 230-235; *Capitalism and Freedom*, beginning page 149.

<sup>12</sup> *Catastrophic Care, Doctored*.

<sup>13</sup> Medicare Not Such a Budget Buster Any More, *New York Times*, August 27, 2014.

Medical care has gone far astray from a market where decision making is sensible. Medical insurance as a federal tax deduction has introduced great distortion, perverse incentives, a “tyranny of rules,”<sup>14</sup> and greatly reduced flexibility. Maybe the situation will change. Reform toward better, customer-enabled decision making is discussed in *Catastrophic Care*.

Kahneman praises physicians in connection with recognition of complex patterns. But supplementing the System 1 skills of physicians with systematic record keeping and analytical procedures (System 2) should lead to improvement.<sup>15</sup> There is potential for much more. As an emerging example, consider a web-based young company called Sherpaa. Businesses and individuals can sign up for an inexpensive service that enables immediate direct access (via phone app) to doctors and other experts. These experts respond to reported symptoms with a diagnosis, write prescriptions or arrange referrals to medical specialists, help in dealing with insurance claims, and help in interpreting and getting errors corrected in medical bills.<sup>16</sup> Such a “disruptive” new competitor can challenge the existing market imperfections, enabling better decision making in getting the services customers want – just as Uber and Lyft are challenging traditional taxi service.

Let me now move to the synthesis.

Kahneman was well aware of Milton Friedman’s writings. In the Conclusions chapter of *Thinking, Fast and Slow*, Kahneman cites Friedman explicitly, with five pages on how “free to choose” can be a recipe for trouble.<sup>17</sup>

Philip Howard’s book *The Rule of Nobody* makes a persuasive case that there is an overabundance of laws and regulations. Many of our political leaders are lawyers, who think that extending the Rule of Law to guide society’s decisions down to fine levels of detail will lead to improvements. But Howard, a lawyer, argues this process has gone too far. We have lost flexibility and adaptability. Our

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<sup>14</sup>Chapter 7 title in *Catastrophic Care*.

<sup>15</sup> *Thinking, Fast and Slow*, pp. 226-9.

<sup>16</sup> [www.sherpaa.com](http://www.sherpaa.com)

<sup>17</sup> *Thinking, Fast and Slow*, pp.411-5.

government is widely perceived as an incompetent bureaucracy. Howard recommends restoring discretion, that government officials be enabled to decide what is reasonable and fair, without being bound by a myriad of specific rules. Such decisions should not be made without citizen involvement. Howard reminds us of Jefferson's words from the Declaration of Independence: "Just powers – derived from the consent of the governed."<sup>18</sup>

Howard provides a poignant example, comparing regulation of nursing homes in different states and countries. Detailed rules and strict enforcement don't assure compassionate care with flexibility to adjust to the needs of individual patients. Rather the opposite may happen: Compliance with rules can inhibit flexibility and compassion.<sup>19</sup> You don't want Nurse Ratched<sup>20</sup> as your caregiver!

*The Fourth Revolution*, by two editors of *The Economist*, describes the ideas of Thomas Hobbes, John Stuart Mill, and Sidney and Beatrice Webb as creating three revolutions in the concept of the nation state. A fourth revolution was proposed but not completed, on the ideas of Milton Friedman. This book has a more international focus than Howard's book: The world is watching the US as an example of how well democracy functions, in comparison to more authoritarian countries with market economies, such as Singapore and China. The authors note:

"... a dangerous paradox is emerging. On the one hand, voters have scant respect for the governments that democracy has landed them with: To varying degrees, they loathe their leaders and regard them as corrupt and inefficient. On the other hand, they assume that democracy is beyond criticism, a permanent feature of political life. They hate the practice, but never question the theory."<sup>21</sup>

The authors continue, "That situation is unlikely to last. ... Democracy has become too sloppy and self-indulgent over the recent decades of prosperity: It is

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<sup>18</sup> *The Rule of Nobody*, p. 176.

<sup>19</sup> *Ibid*, index p. 243, entries for "nursing homes."

<sup>20</sup> A character in the book and motion picture, *One Flew Over the Cuckoo's Nest*

<sup>21</sup> *Fourth Revolution*, p. 251.

overloaded with obligations and distorted by special interests.” The authors’ advice is to “trim the state and revitalize democracy.”<sup>22</sup> They provide specific criticisms and suggestions for both the United States and the European Union. They observe: “globalization is changing politics profoundly.”<sup>23</sup>

The authors of *Fourth Revolution* agree with Philip Howard: “At the moment, laws and regulations are like vampires. Once created, they are impossible to kill.”<sup>24</sup> Both books recommend “sunset” clauses that require laws to be renewed or have these laws expire after a period such as ten or fifteen years. Howard recommends making a sunset provision at fifteen years for most regulatory and social welfare programs as a Constitutional Amendment. He even provides draft language.<sup>25</sup>

Both books also agree on having state and local government take larger role. I like the De Tocqueville quote in *Fourth Revolution*:

Local institutions are to liberty what primary schools are to science; they put it within the people’s reach, they teach people to appreciate its peaceful enjoyment ...Feelings and opinions are recruited, the heart is enlarged, and the human mind is developed by no other means than the reciprocal influence of men upon each other.<sup>26</sup>

(Note - Doesn’t this describe the Chit Chat Club?)

Both books favor more use of technocrats to manage complex issues, rather than giving these issues to legislators. And both describe how lobbyists in Washington D.C. make legislation overly lengthy and complex, allowing special interest provisions to hide in it.

Now, here is my conclusion.

I am in agreement with Bill Nelson and a lot of others: Having over two-thirds of our population think our federal government is not doing a satisfactory job is an

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<sup>22</sup> Ibid.

<sup>23</sup> Ibid, p. 259.

<sup>24</sup> Ibid, p. 266.

<sup>25</sup> *Rule of Nobody*, pp. 179-80.

<sup>26</sup> *Fourth Revolution*, p. 267.

indication of serious trouble. Maybe to a large extent it is apathy – acceptance of an “automatic government” with our domestic affairs in an acceptable status quo. But let’s reflect that there was a near-catastrophe in 2008. And there still are a lot of people in our country who are hurting from unemployment, debt, immigration, etc., and on the wrong side of a growing inequality gap.

I have briefly discussed books that I think are illuminating on how to improve governance. While there is citizen discontent, I think there is little basis to conclude that the problem is that our government is too big, and that the solution is to restore more economic freedom by lowering taxes and cutting regulatory and social welfare programs.

We need to reinvent the way our democracy is working. In my judgment and that of authors I have cited, we need big changes, not politics as usual. Maybe some of those big changes are underway, but I do not yet perceive initiatives for such changes from the leadership of the two major political parties, or in the campaigns underway for the election in November. Possibly we will have proposals for big changes in the context of the upcoming Presidential election in 2016, but there is no indication as yet of an “out of the box” candidate with proposals for such changes. We have a world in flux with globalization, potential for renewed financial instability, terrorism, and regional armed conflicts. Add the threat of the Ebola pandemic spreading in Africa and adverse changes in the environment.

A crisis threatening catastrophe for the global economy suddenly developed about seven years ago. A combination of political leaders and technocrats acted forcefully and quickly. There was not a repeat of the worldwide Great Depression.

How well will we deal with the next big crisis that suddenly appears? Will we choose wisely?

The 20<sup>th</sup> century was a huge success for democracies.<sup>27</sup> Will this success continue? I hope so. I would like to remain optimistic about this country and its

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<sup>27</sup>*The Fourth Revolution*, pp. 252-254.

future, and about having the values and benefits I have enjoyed in this country spread to other parts of our globalized planet.

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