Ten (Mostly) Austrian Insights

For These Trying Times[1]

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By Way of Introduction

I will begin by defending the approach I am taking in this paper, namely an historical approach in which I try to glean insights from great writers of the past that may be of relevance to today. It is significant that I should feel the necessity to defend such an approach, but I am, after all, an economist, and economists typically do not have much patience for the history of economic thought. It is a discipline in which cumulative progress is expected and, by the naive among us, to be the norm. The median attitude is probably well-represented by the old adage that all one really needs to know is what is in the latest working paper. (One is tempted to add: If such people have ever read Thomas Kuhn, they must have done so with their eyes closed.) My approach assumes, to the contrary, that there is much to be learned from the ideas of the past.[2]

Another observation, one commonplace among historians, should also be stressed: history provides no magic bullet. What it provides is perspective. It shows what sorts of ideas our predecessors entertained, the sorts of policies that their ideas led them

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[1] Prepared for the Heritage Foundation Conference on Political Economy. I greatly benefited from comments from participants at Peter Boettke's Workshop in Philosophy, Politics, and Economics at George Mason University, and from additional comments from Larry White. Remaining errors are my own.

[2] It is a view that Friedrich A. Hayek shared. As he put it in the closing of his essay on "Comte and Hegel," "...I doubt whether it is possible to overestimate the influence which ideas have in the long run. And there can be no question that it is our [meaning scholars – BC] special duty to recognize the currents of thought which still operate in public opinion, to examine their significance, and, if necessary, to refute them" (Hayek [1952] 2009 , p. 304).

to, and what transpired as a result. It also allows us to see that our times are not unique,[3] and that as bad as things sometimes seem, there have always been worse times. Think, for example, of what Friedrich Hayek lived through: two world wars, hyperinflation, the creation of the Soviet Union, the great depression, and the creation of the welfare state. That we might learn something from the writings of someone who experienced and responded to such events should be evident.

I mention Hayek because I am a Hayek scholar, so many of my reflections will draw on his ideas and writings. But many others could as easily have been cited, not only those who directly participated in the Austrian tradition, like Ludwig von Mises or Ludwig Lachmann, or the Austrians who were more on the periphery, like Fritz Machlup or Gottfried Haberler, or even non-Austrians like Jim Buchanan, Ronald Coase, Douglass North, or Vernon Smith. I see such scholars as all contributing to a broad tradition that challenges the scientistic pretensions of economics and offer an alternative view of the way that the world works. They are all, I would submit, advocates of basic economic reasoning, the sound core of ideas that economics contains and which we forget only at our peril.

I will close these preliminary remarks by noting that Hayek always kept to the general level of ideas. He was no policy wonk. Instead, by using his knowledge of intellectual history he tried to spotlight that complex of mistaken ideas – constructivist rationalism, scientism, socialism, "the engineering mentality" – that was leading the West down the road to serfdom, and to propose in its place a return to a revitalized liberalism,

[3] What Hayek wrote in 1933, the trough of the Great Depression, about "the recurring intellectual isolation of the economist" who is "bitterly reproached if he does not emphasize, at every stage of his analysis, how much he regrets that his insight into the order of things makes it less easy to change them whenever we please," could as easily have been written by any free market economist of today (Hayek [1933] 1991, p. 18, 21).

one that he described and defended in such works as *The Constitution of Liberty* and *Law, Legislation, and Liberty*.

In what follows I will identify ten key themes to be found in the writings of Hayek and others in the tradition to which he belonged that may provide some insights into how we might respond to the current dilemmas that we face. Some, but not all, might be described as Austrian: hence the awkward but descriptively accurate title of this paper.

1. The business cycle is a necessary and unavoidable concomitant of a money-using market economy.

It is perhaps an exaggeration, but sometimes it seems that people today are surprised to find out that business cycles can still happen. Hayek, whose first book was titled *Monetary Theory and the Trade Cycle*, certainly recognized the problem, as did his rival on this issue John Maynard Keynes.

"Money-using" is a key phrase in the statement above. As introductory economics textbooks remind us, money performs many essential functions, among them to provide a unit of account and a store of value. Its most important function, though, is to facilitate trade, thereby making specialization and the division of labor profitable, and thereby establishing key pre-conditions for economic growth. Money, then, is essential. But as Hayek argued in his first book, **money is also the loose joint** in a free market system.[4] It will be intimately involved in crises.

[4] See. e.g., Hayek [1933] 1966, p. 189: "So long as we make use of bank credit as a means of furthering economic development we shall have to put up with the resulting trade cycles"; p. 185, "...fluctuations caused by monetary factors are unavoidable"; p. 188, "no measure which can be conceived of in practice would be able entirely to suppress these fluctuations." It was in *The Constitution of Liberty* that Hayek

We need not detain ourselves with a full description of the Austrian theory of the cycle here, other than to note that it offers a pretty good description of at least part of what happened in the latest meltdown, especially in terms of the Fed's interest rate policy and its effects on the housing sector. In Hayek's theory, problems start when the **market rate of interest is held too low** for too long. This always politically popular policy leads to **malinvestment** – too many investment projects get started that cannot ultimately be sustained. When people realize what has happened, investment spending collapses and a recession begins. The danger of a prolonged low interest rate regime in distorting (what the Austrians call) the structure of production is something to take away from the theory, especially given the political popularity of such a policy.

If the Austrian theory of the cycle scores pretty well for explaining the origins of at least certain cycles, it is perhaps less useful in telling us what to do when a recession is underway. Hayek talked (at least for a time) during the Great Depression about stabilizing the nominal flow of spending, and he also spoke about providing firms with more information about potential dangers. But his chief message was that, once begun, **the downturn is painful but necessary medicine for restoring equilibrium to the economic system**. This suggests that the best policy is to do nothing, to let the economy adjust.

One can understand the reasoning, for it is clear that at least some attempts to stimulate the economy can simply **perpetuate the problem**. If the chief problem is that (as the Austrians would put it) the current structure of production does not accurately reflect the true demand for goods in the economy, you certainly do not want to undertake

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described money as "a kind of loose joint in the otherwise self-steering mechanism of the market…." See Hayek 1960, p. 325.

a policy that serves to preserve that structure of production. Two examples from the recent crisis illustrate well Hayek's position. They involve the automotive and house-building industries, two that in the course of the crisis have been frequently in the news. In late December 2008 GMAC, the lending arm of General Motors, was given a 6 billion dollar bailout by the Bush administration. What did they do with it? Within a day the radio and television were filled with ads saying that GMAC was now providing zero interest loans and lowering its minimum required credit scores from 700 to 621. For perspective, note that the "sub-prime" designation applies to loan applicants with credit scores of 660 and below. So to stimulate the economy and revitalize the automobile industry, a policy was adopted that essentially made it easier for people with bad credit to afford to purchase a car. The other example is the tax credit carrying a maximum value of $8000 offered by the federal government in 2009 for first time homebuyers. The idea, I suppose, was that this would help reduce the inventory of existing homes. Unfortunately it led to a mini-boom (which began showing up in the June housing statistics) in the construction of new single family homes. In other words, this policy further increased the supply of housing at a time when the evident problem was an excess supply of housing. These are paradigmatic examples of how targeted attempts to stimulate demand can perpetuate an initial malinvestment.

Another reason that the Austrians reject discretionary counter-cyclical policy is that it raises the **threat of inflation,** or other ills, down the road, more on which soon.

The reason that the Austrian message has been almost wholly ignored in the current debate is that it is very dour. It is also politically infeasible, for it counsels

politicians to do nothing at a time when all their instincts are to show voters that the government is doing something.

This does not mean, however, that there are no Austrian policies with regard to the business cycle. Most of these have to do with tightening up the loose joint of money, that is, with institutional reforms aiming at preventing a money-induced cycle from getting started in the first place. Over the course of his long career, Hayek offered a variety of proposals for how to do this. These ranged from committing a central bank to stabilizing the "total money stream," or later an index of wholesale prices, to having the international gold standard operate more automatically, to allowing individuals to have freedom of choice among currencies, to avoiding a government monopoly by allowing the competitive issue of private currency.[5] Various alternative monetary regimes, all designed to make money less of a problem, have been advocated by present day Austrian economists, and such ideas need to be more widely disseminated and debated.[6] Given that a change in institutional structure is a radical proposal that few will ever be willing even to consider, rather than arguing directly for it, perhaps a better first step is to show the dangers of current policy. In this case, this means warning about the dangers of the revival in interest in Keynesian sorts of remedies.

2. The 1970s and why Keynesian economics was rejected

Indeed, it was the 1970s experience with Keynesian policies that got Hayek writing about macroeconomics again. It provided for him the quintessential example of the dangers of scientism. Thus in the introduction to his Nobel lecture, aptly titled "The

[5] See, e.g., Hayek 1935, p. 131; 1937 [1999]; 1960, pp. 333-37; [1976] 1999; [1978] 1999. For a critique of the consistency of certain of Hayek's proposals, see White 1999.
[6] See, e.g., some of the literature in the "Free Banking and Monetary Policy Links" section of Larry White's homepage, http://www.umsl.edu/~whitelh/.

Pretence of Knowledge" (Hayek [1974] 1978, p. 23), he said, "economists are at this moment called upon to say how to extricate the free world from the serious threat of accelerating inflation which, it must be admitted, has been brought about by policies which the majority of economists recommended and even urged governments to pursue. We have indeed at the moment little cause for pride: as a profession we have made a mess of things."

There were good reasons why Keynesianism went into eclipse in the 1970s. Though the theory had entered academia decades earlier, the first real experiment with Keynesian demand management policy was the Kennedy-Johnson tax cut, and it worked like a charm. Economists began to talk about "fine-tuning" the economy, a wonderful metaphor, conjuring up the images of a skilled technician working on a finely-tuned machine, and also perhaps the "fine-tuning" of FM radio, the latter appealing to the innate good taste of the intelligentsia.

The heyday did not last long. When inflation began to appear in the late 1960s due to the monetization of LBJ's deficits, a precisely calibrated income tax surcharge designed to tamp down demand was imposed. But because it was viewed as temporary, it had no effect, and inflation continued to rise. This was the first signal that the machine metaphor might have been the wrong one.

Things got much worse in the 1970s, as inflation turned into stagflation. The main lesson of the 1970s was that once inflation gets started, it is very difficult to get rid of. To fight it the government has to tighten up on the economy, which induces unemployment, and because the effect on inflation is not immediate, for a time both the unemployment rate and the inflation rate go up together. This politically disastrous outcome led to all

sorts of bizarre policy experiments: wage-price controls under Nixon; WIN buttons under Ford; and Jimmy Carter's sad little malaise speech (which, when people started spending again, he had to follow shortly thereafter with a "just kidding, don't spend so much" admonition). The basic problem was that, until Paul Volcker came along, policy-makers in the 1970s would start to restimulate the economy before inflation was fully driven out of the system, leading to a stop-go policy that was exacerbated by oil shocks and structural changes in the labor market (the entry of young people and women into the labor force). Stagflation was the end result, and it was not wrung out of the system until Volcker induced a very long and real recession – the worst one since the great depression and the one that our current downturn should be compared to. In short, **the worst recession since the great depression 1) was consciously policy-induced, and 2) was made necessary by the failed attempts at activist discretionary counter-cyclical policy during the previous decade and a half.** This history needs to be recounted! It is hard to imagine a more vivid cautionary tale, and explains why Keynesian demand management policy went so rapidly into eclipse three decades ago.

Am I forecasting that stagflation will reoccur? No, because the economy is too complex to make any such prediction, another Hayekian insight, more on which anon.[7] But it is clear that if one at the same time puts record amounts of money into the financial system (as the Fed has done to provide liquidity) and at the same time the federal government runs record-breaking deficits which promise to exist far into the future, the

[7] That there is a tension between Hayek's early step-by-step account of the unfolding of a typical business cycle, and his later work on complex phenomena, should be evident. I prefer his later work.

I learned my lesson about forecasting firsthand in 1984, when the existence of large (by the standards of the day) federal deficits as the economy was nearing full employment led me boldly to predict to my classes that either a recession (if government borrowing to finance the deficit pushed up interest rates) or inflation (if the fed monetized the debt) was coming. I was of course wrong. The government started to sell bonds overseas, allowing us to escape the dilemma, a policy we have followed ever since. The ultimate effect of this policy may soon be revealed.

chances of any plausible exit strategy working without some sort of problem emerging becomes quite remote. As Clive Crook (2009, p. 7) of the *Financial Times* put it in July 2009, "What the stimulus gives, the debt projections take away."

3. Some regulation is necessary, but....

How can we avoid such problems in the future? The answer that many would give is that we need more regulation: as Mark Calabria (2009, p. 1) of the Cato Institute has put it, "the growing narrative in Washington is that a decades-long unraveling of the regulatory system allowed and encouraged Wall Street to excess...".

Hayek faced an analogous dilemma in 1930s. Free market capitalism had apparently collapsed, and the favored solution to the problems of the depression was again more regulation, which then went under the rubric of "planning." Indeed, his friend Lionel Robbins (1937, p. 3) described planning as "the grand panacea of our age." The problem was, then as now, that the word "planning," like the word "regulation," can mean just about anything.

Hayek's strategy was not to deny the necessity of planning. We all plan, after all. It was rather to show, first, how a certain type of planning, namely central planning of the economy, if fully implemented, would lead to disastrous economic results and ultimately to restrictions on political and personal freedoms. He made this argument in his 1939 pamphlet "Freedom and the Economic System" (Hayek [1939] 1997), and developed it further in his most famous work, *The Road to Serfdom* (Hayek [1944] 2007).

In these works, as well as other writings of his in the 1930s and 40s, Hayek made it clear that he was not advocating as an alternative a system of pure laissez faire. The

sort of planning that Hayek favored was a general system of rules, one that would best **enable individuals to carry out their own plans**. He put it this way,

> We can 'plan' a system of general rules, equally applicable to all people and intended to be permanent (even if subject to revision with the growth of knowledge), which provides an institutional framework within which the decisions as to what to do and how to earn a living are left up to the individuals. In other words, we can plan a system in which individual initiative is given the widest possible scope and the best opportunity to bring about effective coordination of individual effort (Hayek [1939] 1997: 194).

Now, as I warned at the outset, Hayek is talking here (as was his wont) at a very general level. In *The Constitution of Liberty* and other writings he would provide a little more detail, laying out the set of social institutions that he thought would best enable individuals to utilize their own knowledge to carry out their own plans. These institutions included a market system, in a democratic polity, with a system of well-defined, enforced, and exchangeable property rights, protected by a strong constitution, and operating under the rule of law, in which laws are stable, predictable, and equally applied. Hayek's goal was to enunciate a framework for the creation of a new form of liberalism, one appropriate for the twentieth century and beyond.

But what he came up with was still very general.[8] Even so, Hayek's contribution here was to stress the importance of the institutional setting, and in that regard he was

[8] One is entitled to ask: Why was Hayek so loath to fill in the details? My conjecture is that his decision was strategic: he was trying to keep a liberal coalition intact during the years in the wilderness. The various

way ahead of his time. For markets to work effectively they must be **embedded in a set of complementary social institutions**. The new institutional economics associated with the work of Douglass North, Ronald Coase, and Oliver Williamson, as well as the experimental work of Vernon Smith, all take off from this basic insight.

Those institutions seem well secured in most of the developed world. But it is also true that they can be brought to ruin virtually overnight by a dictator. The experience of Zimbabwe under Robert Mugabe should be carefully examined by every student of development on the planet. It is a case study in how to dismantle a society, and each step that was taken there can be well-described as a negation of one of the principles articulated in Hayek's general vision for a liberal society.

4. ... a lot of regulation, what Hayek called 'legislation,' is fraught with problems, and can make matters worse.

Hayek was less diffident when it came to pointing out the problems with socialist planning, and many of his warning are applicable with very little tweaking to the current scene.

Hayek thought that a planned system with prices set by the government would always be playing catch-up with the rapid price adjustments that occur in a free market system. In a like manner, regulation cannot keep up with market innovation. New sets of regulations always target problems that arose in the *last* crisis. This does little to address

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liberals who attended the Mont Pèlerin Society ranged all over the map in terms of the sorts of institutions they thought would be acceptable. On the matter of anti-trust, for example, members varied from strict laissez faire to use of anti-trust statutes to ordo-liberalism to certain variants of social market economy under which the planning of the competitive environment became very intrusive indeed. Had Hayek provided too many details, he would perforce be taking sides.

the problems of the next crisis, and indeed sometimes the new regulations make things worse. An example of this is the "mark to market" accounting rule that was put into effect in 1993 following the savings and loan debacle. As noted by Paul Davies of the *Financial Times* (Davies 2009), recent research supports the common sensical notion that a mark to market requirement tends to accelerate and exacerbate the effects of a downturn, making the collapse of a number of financial institutions inevitable. If there is a period during which there is no market for certain assets held on their books, banks are required to declare them as worth zero. Needless to say, that takes quite a toll on a balance sheet. The basic Austrian insight here is that **entrepreneurs** (including those who realize that there is money to be made from devising ways of getting around regulations) **are always forward-looking, while regulators are almost of necessity backward-looking**.

Regulation also inserts **uncertainty,** or as Hayek put it, "...the more the state 'plans,' the more difficult planning becomes for the individual" (Hayek [1944] 2007, p. 114). There was plentiful evidence of the adverse effects of regime uncertainty in the recent downturn. In the fall of 2008, each announcement by the Fed and Treasury, meant to reassure the markets, produced more and more panic. It also froze people into inaction. One could imagine the decision-making process that took place in many people's minds. Should I hold onto my house that is underwater, in the hopes of a government bailout? Should I buy a car now that the prices are low, or wait for some government program that will cause them to fall even lower? A stimulus plan is coming, and I don't know what it will look like; probably best to delay all decision-making for now, to wait and see. Over and over again we encounter examples of people basing their decisions on trying to guess

what the government is going to do.[9] Contrast this with what happens in well-functioning markets, where people make their decisions principally by looking at changes in market prices, prices that reflect underlying scarcities.

A third problem is the tendency for even the most well-intentioned legislation to be **hijacked by strong special interests** who are able to bend it to meet their needs. The examples of this are so everywhere evident (think of the subsidization of ethanol, or the explosion in the use of earmarks) that further comment seems unnecessary.

Certain types of legislation, often justified as helping those in need, simply encourage bad behavior, causing **increased moral hazard and misaligned incentives**. Bailing out those who took large risks, be they homeowners, firms, or banks, are the standard recent example, as is the "too big to fail" philosophy more generally. About the latter, Hayek, writing in the latter half of the 1970s, had this to say:

> We must finally mention another instance in which it is undeniable that the mere fact of bigness creates a highly undesirable position: namely where, because of the consequences of what happens to a big enterprise, government cannot afford to let such an enterprise fail (Hayek 1978, p. 82).

He goes on to recommend that the best policy would be to deprive government of the power to provide such protection. At the time he doubtless had in mind the federal government's bail-out of Chrysler. It is telling and pathetic, but perhaps predictable, that

[9] John Authers 2009, p. 21 quotes one risk manager who put it this way: "...it's not just about the classic factors like equity, or default, or interest rates, or inflation or liquidity. There's also a risk factor, which is public policy. Whether we like it or not, government has become an integral part of markets."

the very same arguments about being too big to fail were being made about the very same American industry some thirty years later.

Another problem with legislation is: **Who is to watch the regulators?** The most notorious example here is probably still the inglorious episode of the Keating Five. The Austrians would note that the market provides its own very effective regulators: they go by the names of profit and loss.[10]

Finally, and most basically, **legislation endangers liberty**. Hayek argued passionately in the 1930s and 1940s that the nation's uncritical enthusiasm for planning put at risk not only the successful operation of a market economy, but democracy and freedom as well. It is no less true today. He found it appropriate then to quote Benjamin Franklin, who said "Those who would give up essential liberty to purchase a little temporary safety deserve neither liberty nor safety" (Hayek [1944] 2007, p. 156). We might add, and are likely to get neither.

Hayek knew well that the urge to regulate is always with us. He attributed this in his early work to the hubris of reason, and traced its origins to the planning mentality and scientistic pretensions of his age.[11] But as he pointed out in his 1933 address, the power of markets to organize human activity was in the past most dramatically revealed when we witnessed the ills effects of attempts to regulate them. This has been the experience of centuries, and is another reason why the study of history is an essential component of a proper education.

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[10] The classic citation is Mises ([1951] 1952).

[11] In later work, e.g., Hayek 1988, chapter 1, he attributed our resistance to markets to the fact that a market society satisfies neither our reason (we always think we can improve on market outcomes) nor our instinct (our hunter-gatherer heritage led to certain moral positions – distrust strangers, deal only with parties you know in face to face situations – that do not fit in well with market interactions).

5. The economy is an example of an essentially complex phenomenon, for which precise forecasting (on which the construction of rational policy depends) is ruled out.

Earlier I refrained from forecasting the likely outcome of the injection of unprecedented amounts of money into the financial system together with a massive fiscal stimulus program. I did so because we simply do not know what will happen. It is hard enough even to assess past events. Starting in fall 2008, the U.S. unemployment rose much faster than had originally been predicted, and indeed exceeded forecasts of what it would have been *absent* any stimulus package (so much for forecasts). Paul Krugman's response to this was that we needed a larger stimulus package. The response of most Republicans was that it showed that a stimulus program that depended a lot on increased spending simply doesn't work, and recommended in its place tax cuts, arguing that they would work more quickly. Larry Summers, playing the role of the baby bear, said that it was just right (Crook, 2009). The point is, no one really knows; each position is consistent with the evidence, and indeed, other reasonable explanations are possible. (For example, another plausible scenario is that the announcements that were made in fall 2008 concerning the dire shape of the financial sector, whose purpose was to get the TARP bailout passed, in fact caused the ensuing recession to be much worse than it would have been.) But the point is that we just can't know.

This knowledge problem is a huge obstacle to rational policy-making. When it is joined with other political and economic obstacles, the hope of getting rational policy out of Washington becomes very dim. We know, for example, that there is a lag between the time a problem in the economy is recognized and a policy response is developed, and

another between the introduction of a policy and its actually taking effect. We have plentiful evidence that the political process sometimes subordinates the stabilization goal to other government policy goals, or simply to the self-interested goals of congressmen and senators. We know that tax cuts, despite Republican rhetoric, sometimes get saved rather than spent, so have little stimulative impact. We know that lower interest rates will not accomplish much if banks are fearful of lending or firms are fearful of borrowing: as it used to be put, you can't push on a string. In sum, the things that we actually do know all concern limitations on our knowledge and on our ability to formulate and carry out rational policy.

It is important to be clear: this does not mean that policy-makers cannot get things right when it comes to managing the economy as a whole. It is just that sometimes stabilization policy stabilizes the economy, and sometimes it destabilizes it, and we usually can't tell in advance, and sometimes not even in retrospect, which scenario is unfolding or has unfolded.

6. The two sides of unintended consequences when dealing with complex orders.

Hayek talked a lot about the unintended consequences of intentional human action. Following Menger, the founder of the Austrian School, he pointed out that **many beneficial social institutions have emerged gradually and spontaneously throughout human history.**[12] No one, for example, *invented* language, perhaps the most useful and universal of human institutions, and indeed conscious attempts to construct a non-natural

[12] Menger ([1871] 1976, chapter 8 on origins of money is a classic example; see also Menger's [1883] 1985, p. 146 (emphases in the original), formulation of the key question: "*How can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a* ***common will*** *directed toward establishing them?*"

language – think of Esperanto – have been miserable failures. Other such institutions include money, the division of labor, trade, and the moral traditions (David Hume's three "fundamental laws of nature," namely "the stability of possession, of its transference by consent, and of the performance of promises," come to mind[13]) that support a market system. These institutions have created social cooperation on a global scale, leading to enormous increases in material wealth, even though that outcome was not the intent of any individual participant. Indeed, each individual participant has only a tiny bit of knowledge that they bring to the whole process. I know how to wait tables, you know how to raise chick peas, someone else is a skilled worker in a linen factory, and from these people's efforts and those of hundreds of thousands of others, every day, Paris gets fed, though it was no one's plan, goal, intention or desire to feed Paris. From Frédéric Bastiat to Leonard Read, many have marveled at this unintended miracle.[14] And indeed, Hayek often used the word "marvel" to describe the workings of the market mechanism.[15]

The bad side of unintended consequences is that **many attempts to impose our will on the complex adaptive system that is the economy cause things to happen that were no part of our original intention**. For example, as everyone recognizes, a market system does not satisfy our longings for "social justice."[16] In response, good intentioned

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[13] David Hume [1739] 1890, vol. 2, pp. 258, 293. Hayek frequently quoted Hume on this; see, e.g., Hayek [1963] 1991, p. 109; 1967, p. 99; 1988, p. 34.

[14] The authors, respectively, of *Economic Sophisms* [1845] 1996, and *I, Pencil* [1958], 1999.

[15] Hayek [1945] 1948, p. 87: "I have deliberately used the word 'marvel' to shock the reader out of the complacency with which we often take the working of this mechanism for granted. I am convinced that if it were the result of deliberate human design, and if the people guided by the price changes understood that their decisions have significance far beyond their immediate aim, this mechanism would have been acclaimed as one of the greatest triumphs of the human mind."

[16] As Hayek [1946] 2009, p. 65, put it in "Individualism: True and False," "We must face the fact that the preservation of individual freedom is incompatible with a full satisfaction of our views of distributive justice." He would later come to consider the very term "social justice" to be a dangerous misuse of the

people (or those with interests who can play on the sentiments of the good-intentioned) naturally seek to make adjustments in a market system so as to produce more desirable results. Unfortunately, time and again history has demonstrated that when aiming at certain ends, particularly when their achievement involves interfering with the workings of the price mechanism, all sorts of pernicious effects will occur that were no part of the original intention. Some of these patterns are so well-established that they have worked their way into our basic economic reasoning, more on which in a moment.

Hayek was not opposed to experimentation and change, which indeed is one of the driving forces in both the competitive market process and cultural evolution. He thought, though, that piece-meal change is always preferable to wholesale attempts to remake society anew, quoting to make his point Adam Smith's wonderful lines from *The Theory of Moral Sentiments* [1759] 1976 on the dangers of "the man of system."

> The man of system....seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chessboard. He does not consider that the pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chessboard of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it (Smith, quoted in Hayek, 1973, p. 35).

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language: the second volume of *Law, Legislation and Liberty* carries the provocative title *The Mirage of Social Justice.*

When the man of system is also a man of genius, someone popular and well-trusted by the public, who "declaims and insists, not only that the special improvement is a good thing in itself, but the best of all things, and the root of all other good things," the situation becomes especially dire.[17]

7. Basic economic reasoning captures what we can know and say about the essentially complex phenomenon that we call the economy.

Hayek argued that, when dealing with spontaneous orders or other complex adaptive systems, often the best that we can do is to make pattern predictions, or to offer explanations of the principle by which a phenomenon may work.[18] His examples were usually drawn from areas other than economics. Thus he explained that we all can understand the principle by which footpaths are formed, even if we never observed one being created (Hayek [1952] 2009, p. 104). He noted that the theory of evolution allows us to understand how speciation works, and to rule out certain evolutionary changes, but it does not allow us to predict specific changes that will occur (Hayek, [1964] 1967, pp. 31-34.) What might constitute equivalent sorts of explanations or predictions in the domain of economics?

In my view, **the basic sorts of insights about the workings of a market order that economists teach in their introductory classes**, what I have elsewhere (Caldwell, 2004, chapter 15) called basic economic reasoning, **is what Hayek was talking about when he discussed 'explanations of the principle' and 'pattern predictions**.' These insights have evolved slowly, emerging in the writings of the great economists of the past three centuries or so, and are now captured in such everyday classroom constructions as

[17] Hayek 1960, p. 190. Hayek was quoting Walter Bagehot on the "man of genius," and was using it to deride Franklin Delano Roosevelt's attempt to pack the Supreme Court.
[18] For more on these concepts, see Hayek [1955] 1967; [1964] 1967.

supply and demand curves and production possibility frontiers. These tools allow us to talk about the fundamental fact of scarcity, the choices that scarcity makes necessary, the costs of choice, and of ways to push back against scarcity, at which point the notions of the division of labor, specialization, comparative advantage, the productivity of capital, and the gains from trade are introduced. If one adds to these the concepts of elasticity of demand and supply, and some basic intuitions about market structures, one can explain an awful lot about the world, as anyone who has ever taught an introductory economics course knows.

I say "basic intuitions" above to emphasize that this does not have to be complicated; there is a reason why the introductory course is often labeled "Principles of Economics." I once had a conversation with a colleague about cartels. The person was a technically well-trained game theorist, and game theory is custom-made to analyze things like cartel behavior. I mentioned to her in passing the three conditions that must be met for a cartel to be able to continue to keep prices high through time (a large share of total output, no close substitutes for the product, and the ability to catch and sanction those who cheat on the collusive agreement) and said that I didn't worry too much about cartels because it is difficult to maintain all three conditions. This insight emerged in the 1940s and 1950s, before game theory had swept the profession, and is something that is easily explained with a few supply and demand curves to first and second year college students. Sadly, from the look on her face it was clear that she had never heard of the three conditions.

The principles course, if well-taught, is probably the most important course that anyone who wants to understand how a market system works can take. It shows how

markets work, and also how they sometimes fail to work. It also helps one to identify which policy problems are real ones, and which are pseudo-problems. For those, for example, who are worried about the world running out of a natural resource like oil, it shows how the unhindered market very effectively deals with such shortages (the price of oil rises, which encourages conservation on the demand side, and makes profitable the search for new supplies of oil, as well as for substitutes, on the supply side).

Many of the most compelling examples in a principles class, however, have to do with bad policy responses, and most of these involve some form of price-fixing. Case studies that look at the effects of minimum wage laws, of agricultural price supports, of rent controls, of comparable worth policies, of price ceilings on gasoline or natural gas, of laws prohibiting the resale of concert tickets, all drive home the very predictable adverse effects of these policies. It is ironic that in a field in which forecasting is so difficult, the one area where it is relatively easy to predict results is when some form of price-fixing is involved. Indeed, in the case of price ceilings, the effects are so predictable that economists have come up with generic categories (e.g., the emergence of black markets, deterioration in product quality, and the emergence of non-price mechanisms for the allocation of the good) to describe the effects of the intervention.[19]

A good economics course will help to identify more appropriate policy responses, responses that utilize markets rather than fixing prices or trying to legislate specific outcomes. The entire field of "free market environmentalism," with its emphasis on the establishment of property rights and on the design of institutions that make the best use of market mechanisms, is a case in point.

[19] It is important to note that such predictions always contain a ceteris paribus clause. If market conditions have changed so much that, for example, a minimum wage law fixes the minimum below the going wage rather than above it, it will have no effect: it is not "binding."

Last but not least, a good principles of economics class can serve as a counterweight to some of the widely-held myths that pass as facts within the popular culture.[20] Take the critique of "neo-liberalism," as recently articulated by Naomi Klein in her book *The Shock Doctrine* (2007). According to Klein, neo-liberals embrace the shock doctrine, the idea that multi-national corporations should enlist the power of national states during times of crisis (sometimes crises that they are complicit in fomenting) to impose a world-wide regime of free trade, thereby ensuring a steady supply of resources from less developed countries, a steady market for their goods world-wide, and a steady flow of profits to their owners. I encourage you to read Klein's book. Half of it could have been written by Murray Rothbard: I refer here to the places where she talks about the dangers to our liberties and economic freedoms when big states and big corporations collude, or where she documents in sickening detail case after case of states trampling on the civil liberties of its citizens, from Chile and Argentina to Russia and China. A good libertarian could take the facts documented in the book and construct a devastating case about the dangers of untrammeled state power. Unfortunately, Naomi Klein was raised by socialist parents in Canada and apparently never had an economics course, so that is not the argument that she offers her reader.

Instead, she makes the fantastical accusation that economists from the University of Chicago, and in particular Milton Friedman, developed the doctrine to support the power of corporations and their owners. She is exactly wrong, of course, about Friedman's position. He supported free trade for a number of reasons, but a principle one was that it serves to *limit* the power of corporations.

[20] As Henry Simons (1983, p. 3) put it in his economics syllabus, "Economics is primarily useful, both to a student and to the political leader, as a prophylactic against popular fallacies."

Rather than an extended argument, I will only offer here an anecdote to illuminate Friedman's position.[21] When I was in graduate school I was fascinated about the question of oligopolies. Markets work well when they are competitive, but what happens when an industry, like the U.S. automobile industry in the 1960s and 1970s (this was before it was evident that the oil embargo and the subsequent increase in the price of gasoline would being the American automobile industry to its knees, and to Washington, to beg for protection), grows too powerful? How could such powerful firms be constrained? I got my answer one day when Milton Friedman came to speak at a nearby university. I chanced to run into him as he was leaving the auditorium after his talk, so I asked him his opinion on the matter. He turned to me, put his hand on my shoulder (he had to reach up to do that, a unique experience for me, because I am not tall), and asked, "Now given your knowledge of economics, what one policy could we implement that would limit the power of the automobile industry?" "Open up our markets to foreign competition?" I ventured. He smiled, patted me on the shoulder as if to say, "Good boy," and went on his way.

Sadly, this basic insight, that international trade is a way of constraining the power of large domestic firms, has little traction among the oceans of protesters who show up at every trade meeting. They do not realize that the policies that they favor would, by granting them protection from foreign competition, make American corporations more powerful.

8. But what about social justice?

[21] Those interested in a more detailed response to the critics of neo-liberalism should consult Caldwell 2011.

As noted above, Hayek recognized that a market system of necessity results in an unequal distribution of income. And he knew that humans, whose ancestors for hundreds of millennia lived in hunter-gatherer tribes, had developed norms of fairness that would resist the presence of such inequalities. Indeed, many critics of markets cite disparities in income as prima facie evidence of lack of fairness. Of course, the causes of income inequality are many, from differences in everything from initial endowments to effort to intelligence to luck. We usually do not think it unfair when someone who works hard succeeds, and only the most curmudgeonly among us would begrudge someone who has experienced a run of good luck, if only because we all wish it for ourselves. Still, the wide disparities in income that a market system naturally generates inevitably fuels calls for reform, for some sort of "social justice." How might one respond? Must those who favor markets argue for social *injustice*?

Hayek viewed the cry for social justice as both misguided and dangerous, and offered a number of arguments why. His first claim was that it was wrong even to apply the concept of "justice" to something like an impersonal market process. For Hayek, justice is an attribute of human conduct. As such, a person's or an organization's actions may be deemed just or unjust. The market process generates a specific income distribution, but because that distribution was not the result of anyone's design, it is wrong to speak of a it as just or unjust, just as it would be wrong to speak of, say, a misfortune (contracting a disease, or losing a loved one) as just or unjust.[22]

A second argument invokes the rule of law, the notion that all people should be treated equally under the law. If we accept this principle, equal treatment of all, and then add the observation that people differ in their attributes, we are led naturally to the result

[22] Hayek 1976, pp. 31-33.

that different people will experience different outcomes. Conversely, the only way to get similar outcomes for different people is to treat them differently. Egalitarianism of this sort goes against the rule of law, and more generally, against the idea that, if we set up a game in which the procedural rules are viewed as fair, a particular outcome might be viewed as unfortunate, but it cannot rightly be judged to be unfair.[23]

A third argument is that, even were one to accept the general desirability of some form of redistribution of income, the principles by which it might be made to work are unclear, and often presume that we possess knowledge which we can never possess. Take, for example, the notion that we should reward people according to "merit." Hayek points out that merit typically is

> ...not a matter of the objective outcome but of subjective effort. The attempt to achieve a valuable result may be highly meritorious but a complete failure, and full success may be entirely the result of accident and thus without merit (Hayek 1960, p. 95).

It should be noted that if we set up a merit system in which we rewarded people according to their efforts, regardless of outcome, those who were least skilled and therefore had to try the hardest would get rewarded the most, and those who achieved much by little the least. This is a system that, if one is concerned with the total amount of

[23] Hayek 1960, p. 87: "From the fact that people are very different it follows that, if we treat them equally, the result must be inequality in their actual position, and that the only way to place them in an equal position would be to treat them differently. Equality before the law and material equality are therefore not only different but are in conflict with each other; and we can achieve either the one or the other, but not both at the same time." Not all market critics would accept, of course, that the "game" is fair.

goods produced, is as perverse a system as one can imagine.[24] But leaving that aside, the simple fact is that, because merit is a matter of subjective effort, we could never have the knowledge necessary to determine which acts are in fact meritorious.[25]

Somewhat controversially in the eyes of certain Austrians and libertarians, Hayek allowed that, for a society that had reached the general level of wealth that Britain or the U.S. had achieved, "there can be no doubt that some minimum of food, shelter, and clothing, sufficient to preserve health and the capacity to work, can be assured to everybody" and also that the state should "assist the individuals in providing for those common hazards of life against which, because of their uncertainty, few individuals can make adequate provision" (Hayek [1944] 2007, p. 148; cf. Hayek 1960, pp. 285-86). He was, in short, in favor of some form of safety net, though it should also be noted that by the 1970s he worried about coalitions of organized interests, and often well-off special interests, who would use pleas for greater social justice to advance their own ends.

Wherever one might come down on the desirability of a safety net, perhaps the strongest argument for a market system is that it has led to a better standard of living for literally billions of people world-wide. The point has been well-made by Peter Saunders in his memorable piece, "Why Capitalism Is Good for the Soul."

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[24] In describing how a market system allocates rewards, Hayek 1976, p. 72, emphasis in the original, notes: "The long and the short of it all is that men can be allowed to decide what work to do only if the remuneration they can expect to get for it corresponds to the value their services have to those of their fellows who receive them; and that *these values which their services will have to their fellows will often have no relations to their individual merits or needs*."

[25] Hayek 1960, p. 95: We can draw distinctions of merit "...only where we possess all the knowledge which was at the disposal of the acting person, including a knowledge of his skill and confidence, his state of mind and his feelings, his capacity for attention, his energy and persistence, etc. The possibility of a true judgment of merit this depends on the presence of precisely those conditions whose general absence is the main argument for liberty. It is because we want people to use knowledge which we do not possess that we let them decide for themselves."

> The way this [capitalism] has enhanced people's capacity to lead a good life can be seen in the spectacular reduction in levels of global poverty, brought about by the spread of capitalism on a world scale. In 1820, 85% of the world's population lived on today's equivalent of less than a dollar per day. By 1950, this proportion had fallen to 50%. Today it is down to 20%.... In 1900, the average life expectancy in the 'less developed countries' was just thirty years. By 1960, this had risen to forty-six years. By 1998, it was sixty-five years. To put this extraordinary achievement into perspective, the average life expectancy in the poorest countries at the end of the twentieth century was fifteen years longer than the average life expectancy in the richest country in the world – Britain – at the start of the century (Saunders 2007-08, p. 5).

From this perspective, the extension of free markets, while leading to income inequality, simultaneously increases the total size of the pie to be shared, and thereby benefits mankind as a whole. There are many ways to think about "social justice." Advocates of markets would do well to emphasize benefits that extend to the world as a whole.

9. The basic Hayekian insight – how freely adjusting market prices help solve the knowledge problem and allow social coordination.

How has the market system, what Saunders calls capitalism, been able to accomplish so much in such a short time? For Hayek, the answer was that markets allow for the coordination of individual plans on a vast scale – in short, markets help to solve "the knowledge problem."

Hayek's best articulation of the process is contained in his classic 1945 essay "The Use of Knowledge in Society" [1945] 1948. He begins there by asking a very simple question: What problem must we solve if we want to construct a rational economic order? He points out that *if* (and he italicizes the *if*) we had all the relevant information about preferences, endowments and technology, the problem solves itself, for it is simply a question of logic. In such a world, we could put everything into the hands of a central planner, who would then allocate resources and goods to their highest valued uses.

All of the *problems* for constructing a rational economic order arise precisely because we do not have such information. Instead, in the real world knowledge is dispersed among millions of people. Each person has a bit of localized knowledge, or what Hayek calls "knowledge of the particular circumstances of time and place" (Hayek [1945] 1948, p. 80). In the real world, it is also the case that some people are mistaken about what they think they know. The question that must be solved in constructing a rational economic order in such a world is: how can we use the knowledge that is dispersed among millions of fallible market agents so as to achieve some level of social coordination and cooperation?

Hayek's answer was that a market system, one with freely-adjusting market-determined prices, is (when embedded within an appropriate institutional structure) a marvelous mechanism for coordinating human action. As was noted above, a free market economy is a complex system. It is also an *adaptive* complex system, which helps to explain why it works. As Hayek illustrates with his famous tin example, whenever a change occurs somewhere in the system, price adjustments immediately signal millions

of market participants that something has changed, and this causes some of them (those on the margin) to adjust their behavior, which of course sends further signals out into the system, causing further adjustments, ad infinitum.[26] As Hayek put it, "The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all" (Hayek [1945] 1948, p. 86).

In a world that is filled with unpredictability, where "the man on the spot" has only his own small bit of local (and sometimes tacit) knowledge, market signals provide information on which he can base his decisions. His decisions together with those of millions of others, in their turn, feed into the system to form the prices that emerge. The actions of market participants are thereby simultaneously price-determined and price-determining. Bad decisions and mistakes are constantly made. But in a market system, errors made by some are opportunities for others, and the latter's profit-seeking actions help to correct them. The self-regulating market system, when it is functioning well, reduces some of the unpredictability that we all face in the economic arena, and helps to coordinate our actions with those of millions of others. It also allows individuals to act on their own local knowledge, and thereby allows others to make use of that knowledge, even though they do not posses the knowledge themselves.

The flip side of Hayek's insights provides a warning to those who seek to improve on markets. Two sorts of errors are possible. The first is not to recognize that for the vast coordination mechanism to work, agents must be allowed to act on their knowledge, and

[26] The ongoing nature of this process is why Austrian economists usually use terms like "market process" or "evolving market order" when speaking about how markets function rather than "market equilibrium." The last can lead one to the false image of a system making a final adjustment to a state of rest.

prices must be allowed freely to adjust. Many "reforms," of course, do just the opposite, seeking to restrict entry into markets, or keep prices from adjusting, on the grounds of protecting the consumer, or assuring the quality of a product or service, or supporting diversity or equity or balance or fairness, and so on. The second is assuming that decision-makers have more knowledge than they do. Hayek admitted that *if* we had more knowledge we could do a lot more to improve the world. But we don't.[27] And in the world we live in – a world of dispersed knowledge – much of the knowledge we actually do possess is due to the workings of the market mechanism.

10. The basic public choice insight – why government cures so often are not only worse than the disease, but lead to further disease.

Although some have occasionally identified public choice insights in the writings of Hayek and other Austrians (e.g., Boettke 1995), I think that is fair to say that the public choice school is a separate though complementary intellectual development. Just how complementary it is will be evident once the following list of public choice insights has been outlined.

A central claim concerns the **rationally ignorant voter.** Because learning the various candidates' positions on a host of issues is costly, and the chances of an election turning on a single voter's ballot are miniscule, many voters rationally choose not to be very informed about the issues. When one couples this with Bryan Caplan's 2007 argument that public opinion generally favors policies that make voters feel good, or moral, or more American (e.g., raising the minimum wage to fight poverty; attributing a

[27] As Hayek 1983, p. 258, put it in an interview: "What we can know in the field of economics is so much less than people aspire to."

rise in gasoline prices to the greed of oil corporations) but that also make for policy outcomes that most economists, and more educated voters, view as pernicious (e.g., increasing the incidence of unemployment among the least skilled workers; passing "excess profit tax" legislation that reduces the supply of domestically produced oil), it is hard to feel much confidence in the policy that is generated in a democracy. Politicians who seek to be re-elected rationally supply the irrational policies that voters want.

A second claim has to do with the effects of **concentrated benefits and diffused costs** on policy-making. Politicians frequently pay lip service to "the public good." But if a politician is to be successful (that is, stay in office), he or she will typically support policy that is aimed at benefiting the well-organized and informed few rather than the unorganized and uniformed many. As a result, legislation tends to favor special interests over the public good, and once a policy is in place, it is nearly impossible to get rid of it.

Public choice theorists believe that politicians, like everyone else, act in their own self-interest. If consumers maximize utility, firms maximize profits, and politicians maximize votes, what do bureaucrats maximize? The answer is troubling: **bureaucrats have an incentive to maximize the size of the bureaucracy under their control**.[28] Governments don't shrink, they grow. Never has the triumph of hope over reality been better illustrated than by the steady stream of politicians who promise to pay for new programs by "reducing waste and inefficiency" in the existing government.

In their wonderfully-titled 1977 book *Democracy in Deficit*, James Buchanan and Richard Wagner made the point that **democratic politics leads naturally to deficits**. Politicians typically insist that they intend to constrain the growth of government spending, but in reality they seldom are able to overcome (and given the ignorance of the

[28] The classic citation is Niskanen 1971.

electorate, seldom need to do so) the natural incentives of increasing government spending and decreasing taxes. Can anyone remember a politician who campaigned successfully with a platform of *raising taxes*?

The past thirty years have demonstrated this to be one of the few areas in which bi-partisan endorsement of a basic principle has been nearly complete. For a case study of how difficult it is for politicians to actually cut government spending, even when they have a mandate to do so, one need only consult William Greider's classic 1981 piece, "The Education of Davis Stockman." While constantly mouthing the rhetoric of balanced budgets, Ronald Reagan offered up instead tax cuts and substantially smaller cuts in government spending, and won two terms. When George H. W. Bush tried to balance the budget by raising taxes, he was excoriated by his own party and served only one term. After that, the policy of cutting taxes but leaving government spending intact became canonized in certain Republican circles under the cynical "starve the beast" philosophy. For a while, it seemed like the only difference between the two major American parties was that the Democrats favored tax and spend, while the Republicans favored *don't* tax and spend. This changed in 2008, when the Democrats began following the Republican mantra in spades. It seems that no one these days (except Libertarians and Ron Paul) speaks about a smaller government period.

Another central concept in the public choice literature is the notion of **rent-seeking**. Firms can successfully compete in two ways. One is directly, by producing a better product at a lower cost than their rivals. The other is by getting the government to grant them an advantage over their rivals, by the granting of subsidies, or the imposition of licensing restrictions, taxes, tariffs, or quotas on their competitors. Given an expected

level of added profits from getting the government to intervene, a firm would rationally spend up to that amount in lobbying the government to do so. Such rent-seeking behavior is a waste of resources, but takes place all the time. Gordon Tullock once asked, why is the level of rent-seeking as small as it is? Perhaps it is time for him to recalculate his estimates.

We said above that the best regulator for market behavior is the **carrot of profits and the stick of losses**. No equivalent regulator exists when the government undertakes a project. Indeed, if a government program does not achieve its goals, the solution always seems to be, we just need to spend more money.

Finally, it is evident that many government programs introduce **moral hazard** into the market place, undermining initiative and the taking of responsibility for actions. From welfare programs for the poor to welfare programs for the rich (the socialization of losses under the bailout programs being the most recent example of the latter), ubiquitous government intervention makes all of us more likely to seek a handout.

The list of ills that public choice theorists have identified lead one to a general three step principle that if followed can help to minimize the impact of government intervention.[29] In capsule form: Negotiation (as occurs in market exchange) is always preferable to adjudication. If negotiation fails, adjudication that clarifies rights is always preferable to legislation. Only if both negotiation and adjudication fail should one turn to legislation. Unfortunately, too often legislation is the first and only step.

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[29] See Boettke 2001, p. 207. Cf. Hayek, writing in the 1956 Foreword to the American paperback edition of *The Road to Serfdom* 2007, p. 44: "The increasing tendency to rely on administrative coercion and discrimination where a modification of the general rules of law might, perhaps more slowly, achieve the same object, and to resort to direct state controls or to the creation of monopolistic institutions where judicious use of financial inducements might evoke spontaneous efforts, is still a powerful legacy of the socialist period which is likely to influence policy for a long time to come."

Conclusion – the Austrian /public choice one-two punch: we usually do not have the necessary knowledge to intervene effectively, and the political process is such that, even if we did, we still likely would get bad policy, and this together with an ever growing government sector. This is why Austrians and public choice theorists favor smaller government. Especially in today's environment, their insights bear repetition.

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