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DISCUSSION PAPERS ON

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INSTITUTIONAL ECONOMICS

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F.A. von Hayek

Friedrich August von Hayek (1899-1992) is generally regarded as the most influential intellectual figure in the 20th century revival of classical liberalism (Kukathas 1990) and as the most articulate critic of socialist doctrines (Caldwell 1997). He also deserves recognition as one of the preeminent social philosophers of that century. In an age of increasing specialization within the social sciences and the humanities he developed an approach to social analysis and social reform that integrates insights from economics, law, politics, philosophy, psychology and evolutionary theory into an impressively coherent outlook at the foundations and the evolution of social order. Hayek's scholarly writings span more than six decades and include numerous books and articles, republished in a nineteen volumes edition of his collected works (Hayek 1988ff.).

1. Biography

Hayek was born in Vienna on 8 May 1899. He earned doctorates in Law (1921) and in Political Economy (1923) at the University of Vienna, where he became *Privatdozent* for Political Economy in 1929. Interrupted by a year of study in New York (1923-24) he worked from 1921-6 as a legal consultant in a government office in Vienna, directed by his mentor Ludwig von Mises, in whose famous Privatseminar he participated and with whom he founded, in 1927, the Austrian Institute for Business Cycle Research as whose first director he served until 1931. A series of invited lectures that Hayek gave at the London School of Economics in 1931 led to his appointment to the Tooke Chair of Economic Science and Statistics at the LSE, a position Hayek held from 1932 to 1950, the year he was appointed Professor of Social and Moral Sciences at the University of Chicago's Committee on Social Thought. After retiring from Chicago in 1962 he taught as Professor of Economic Policy at the University of Freiburg, Germany, until 1967. A honorary professorship at the University of Salzburg from 1969 to 1974 brought Hayek back to his native Austria. In 1977 he returned as professor emeritus to Freiburg where he died on 23 March 1992. In 1974 Hayek was awarded the Nobel Prize in Economic Science.

2. Hayek's Social Philosophy

About his personal development Hayek has said that he was led "from technical economics into all kinds of questions usually regarded as philosophical" (1967: 91). It was his early work on monetary theory, capital theory and business cycle theory that earned him his appointment at the LSE, and it was about these themes that he engaged in controversies with John Maynard

Keynes, Piero Sraffa and Frank H. Knight in the early 1930s. An important turning point in his scholarly interests is marked by his 1935 English edition of selected contributions to the so called "socialist calculation debate," including Mises' early (1920) article. As Hayek (1976: 7) has noted in retrospect, in preparing this edition he began to develop his growing interest in questions of the nature and unavoidable limitations of our knowledge, and in the issue of what these limitations imply for our theoretical efforts at understanding the social world as well as for our practical efforts at organizing our social life. The concern with these questions, often referred to as the "knowledge problem," was to become the core theme of Hayek's life work.

In Hayek's (1967: 91; 1976: 8) own assessment, the critical step in his move towards social philosophy was his 1937 article on "Economics and Knowledge" (1948: 33-56), an article in which Hayek addressed what he describes as the "central question of all social sciences," the question of how the fragments of imperfect knowledge that exist dispersed in individual minds are coordinated in the social process to allow for productive cooperation among multitudes of persons. With his 1945 article on "The Use of Knowledge in Society" (1948: 77-91), his most often cited publication, Hayek restated and extended his earlier argument, stressing that the "problem of what is the best way of utilizing knowledge initially dispersed among all the people is at least one of the main problems of economic policy - or of designing an efficient economic system" (ibid.: 78f.). In these two articles, which he considered his most original contributions to economics, Hayek developed a fundamental critique of two bodies of thought prevalent at the time, of formal equilibrium economics on the one hand and of socialist concepts of central planning on the other, censuring both of them for failing to account for the theoretical and practical difficulties that are posed by the imperfect, fragmentary and dispersed nature of human knowledge.

The models of mathematical equilibrium economics Hayek accused of providing only a pseudo-answer to the question that they are meant to illuminate, namely, *how markets work*. As he put it, with its "assumption of a perfect market where every event becomes known instantaneously to every member" (Hayek 1948: 45) formal equilibrium analysis begs the very question that an empirically contentful theory of market processes would have to answer, namely how "a solution is produced by the interaction of people each of whom possesses only partial knowledge" (ibid.: 91). Ironically, the failure committed in concepts of central planning is of a very similar kind. While formal equilibrium analysis, by assuming quasi-omniscient market participants, provides only a pseudo-answer to the *theoretical question of*

how markets work, advocates of socialist planning, by assuming perfect knowledge on part of the central planners, provide only a pseudo-answer to the *practical problem* of how effective coordination of economic activities can be achieved in the absence of markets. Assuming that all relevant knowledge is available to, and can be administered by, a planning agency means to beg the question of how such an agency is supposed to come to terms with the fact that much of that knowledge "never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess" (1948: 77), as knowledge that can be activated only by these very individuals.

What, in Hayek's view, was needed as an alternative to theories about the imaginary worlds of quasi-omniscient market participants or quasi-omniscient central planners was a theory that accounts for "the unavoidable imperfections of man's knowledge and the consequent need for a process by which knowledge is constantly communicated and acquired" (1948: 91). He called on his colleagues in the economics profession to turn their attention from the formal statements of equilibrium analysis to empirically contentful "propositions about what happens in the real world" (1948: 46), propositions about how knowledge is factually acquired and communicated (1948: 46). – While his call did not find much response in the profession in his own work Hayek very much pursued the research agenda that he suggested.

The issue of how we acquire knowledge and how "experience creates knowledge" (1948: 47) Hayek has addressed in particular in his *The Sensory Order* (1952), a most unlikely book for an economist and one of his least known, but nevertheless one that, as has been rightly observed (Weimer 1982: 263; Caldwell 1997: 1874) is of greatest systematic significance for his entire work. In this book (it is based on an early manuscript that Hayek wrote in his student days), subtitled "An Inquiry into the Foundations of Theoretical Psychology," Hayek develops a theory of the human mind, the essence of which is in amazing accord with modern cognitive science. Seeking to explain how the human mind establishes its connections "between the input of (external and internal) stimuli and the output of action" (Hayek 1982: 288), Hayek interprets the working of the mind as an adaptive process of constant classification and reclassification on many levels (firstly of sensory perceptions, but also of emotions and concepts), as a process in which conjectural internal models of the outside world are adaptively formed that guide actions.

The issue of how knowledge is communicated and advanced in society is the theme of Hayek's theory of the market as "a system of telecommunication" (1948: 87) and of competition as a *discovery procedure* (1978: 178ff.), a theory that forms the center piece of his work. As Hayek argues, the prices formed in the competitive market process signal to all market participants the relevant *general* information about changes in relative scarcities that they need to know in order to adjust their behavior adequately, utilizing their unique knowledge of the particular circumstances of time and place that apply to them. While communicating, in the most parsimonious fashion, namely through changes in relative prices, information on the relevant *general* effects of their respective economic activities among its various participants, the market process allows individuals to bring to bear the local knowledge that is available only to them, and that could never be communicated to, and utilized by, a central planning agency. Beyond serving in such fashion as a device for utilizing dispersed knowledge, the market serves also as an arena for the continuous competitive exploration of new and potentially better solutions to economic problems, thus inducing the discovery and creation of new knowledge.

The relevance of Hayek's work, not only for economics but for the social and behavioral sciences more generally, is most clearly visible in his theories of *spontaneous social order* and of *cultural evolution* that he has developed as generalizations and extensions of his arguments on the market price system as a communication network and on competition as a discovery procedure. The thrust of these theories is that human societies are highly complex phenomena, and that the processes of social coordination and societal evolution are inappropriately simplified and misconceived if they are approached in the spirit of the mechanistic models of physics (1952b). Acknowledging the complexity of social phenomena means to acknowledge, Hayek argues, that all we can justly aim at in the social realm, as in all areas of complex phenomena, are explanations of the principle and pattern predictions, by contrast to the explanation and prediction of specific events (1967, chpt. 2).

Hayek places his own social theoretical outlook in the tradition of the Scottish moral philosophy, of David Hume, Adam Smith and others, whom he credits with the discovery of "the twin concepts of the formation of spontaneous orders and of selective evolution" (1988: 146). Central to this paradigmatic tradition is a methodological individualism and subjectivism, the notion that social aggregate phenomena are, ultimately, to be explained in terms of the actions and interactions of individual human beings, and that "the analysis of

what people do can start only from what is known to them" (1948: 44), i.e. from their subjective view of the world. Equally central to it is the notion that the productive coordination and division of labor that we observe in society, as well as the rules and institutions on which societal cooperation is based, are to a large measure not due to deliberate planning and conscious design, but to forces of spontaneous mutual adjustment and evolution. From these premises important conclusions are drawn with regard to the limits of our ability to improve our social condition by deliberate design.

A Hayek points out, there are essentially two basic ways in which the actions of individuals can be socially coordinated, namely, on the one hand, through spontaneous mutual adjustment within a framework of general rules of conduct, and, on the other hand, through the specific instructions of a central coordinator. The respective merits and limits of the two kinds of order, *spontaneous order* and *organization* (1973, chpt. 2), have to do, Hayek argues, with the nature of their principal modes of coordination, namely coordination by general rules versus coordination by commands. Command-based organization is an effective method of social coordination where specific, limited purposes are to be achieved through concerted efforts. Its drawbacks are that, because of its reliance on central decisions, it is limited in its capacity to utilize the knowledge dispersed among its individual participants. The advantage of rule-based spontaneous social orders is that, by allowing individuals to pursue their own ends within the general confines defined by the rules, they can utilize and activate to a much higher degree localized, dispersed knowledge. The price that has to be paid for their greater capacity for utilizing knowledge is that the particular outcomes that they generate must inevitably remain largely unpredictable. As Hayek argues, in light of the respective merits and limits of the two kinds of order, prudence requires us to conclude that, while the method of organized, central coordination can be usefully employed to solve a multitude of specific, limited tasks in the private and public realm, it can never be an appropriate foundation for the extended order of an economy or a society at large. There is, as Hayek puts it, ample room for organizations within the spontaneous order of society, but efforts to turn society itself into an organization can only end in disaster.

An important element of Hayek's theory of spontaneous social order is the insight that, while in any rule-based spontaneous order the particular outcomes must remain necessarily largely unpredictable, the general nature of the patterns of outcomes is very well systematically determined by the nature of the general rules that limit the behavior of the participating

individuals. There exists, as Hayek emphasizes, a systematic interplay between the "order of rules" and the "order of actions" (1973: 98; 1967: 66), i.e. between the nature of the "rules of the game" on which the interactions of the participating individuals are based and the nature of the action-patterns that emerge from the individuals' behavioral choices within the rules, - just like the rules of a game of sport allow us to predict, not the specific actions in, or the outcome of a particular play of the game, but the general patterns that we observe on the playing field. In the social realm, Hayek argues, our knowledge of the systematic relation between the order of rules and the order of actions is the principal instrument that we can employ to improve our condition, by choosing rules of the game that can be predicted to generate more desirable overall patterns of outcomes.

Hayek's emphasis on the basic facts of "the dispersion and imperfection of all knowledge" (1952 b: 50) leads him to be highly critical with a mind set that he labels *rational constructivism* or *constructivist rationalism* (1978. chpt. 1). Under this rubric he subsumes approaches to issues of social policy and social reform whose recommendations are based on a "pretence of knowledge" (the title of Hayek's Nobel lecture; 1978 chpt. 2), i.e. on unjustified presumptions concerning the extent of our knowledge and our intellectual powers (1967: 90). The primary target of Hayek's critique are approaches that, like socialist concepts of central planning, amount to the "claim that man can achieve a desirable order of society by concretely arranging all parts in full knowledge of all the relevant facts" (ibid.: 88). Against such claims Hayek points out that, because it is simply impossible for us to take "conscious account of all the particular facts which enter into the order of society" (1973: 13), we must rely on general rules "as the means to create order in social affairs" (1948: 19), and that our efforts at building a better society must largely rely on the *indirect* method of improving the rules and institutions under which we live, instead of on attempts to directly produce desired outcomes through specific interventions, designed by a central authority that directly seek to produce desired outcomes.

In our efforts to improve the framework of rules and institutions under which we live, we need, Hayek stresses, to be no less careful to avoid the pitfalls of a pretence of knowledge, that ignores the limits of what we can reasonably claim to know in matters of institutional design. Since the desirability of the outcome patterns that particular rules or institutions tend to generate can only be judged appropriately in terms of their working properties over extended periods of time, and not by their effects in any particular instance, it would be presumptuous to claim that we can easily design, at the drawing board, rules and institutions

that serve us better than those that have evolved over generations in. Just as, in the ordinary market, the discovery process of competition helps us to find out how numerous "economic" problems can be best solved, competition in the realm of rules and institutions serves the function of allowing us to find out what kinds of rule-arrangements are best suited to allow for mutually beneficial cooperation among multitudes of persons. A process of competitive selection can here, just as in ordinary markets, help gradually to evolve solutions that are much more effective than what any rational design could have ever invented at the outset. In fact, so Hayek argues, the institutions on which our civilization rests, including the rules of the market, must be viewed as the outcome of a process of cultural evolution that extends over thousands of generations and that reflects the experience of many more trials and errors than the most wise and intelligent rule-designer could ever consider (1967: 88). Our efforts at institutional reform and rule-design should, therefore, always be informed by due respect for the wisdom implicit in inherited institutions, and we should expect further improvement "more from slow experimental piecemeal evolution than from redesign of the whole" (1964: 8).

The theory of cultural evolution is the theme to which Hayek devoted much of his later work (1979, Epilogue; 1988), and it is this part of his theory that has become a primary focus of recent discussions on his ideas. A central issue in these discussions is how the notion of competition among institutions – a notion that is at the heart of Hayek's ideas on cultural evolution - is to be specified, and under what conditions such institutional competition can be expected to generate "good" rules, i.e. rules with working properties that are desirable to those who are affected by them (Vanberg 1994, chpt. 6).

3. Impact and Significance of Hayek's Work

With his arrival at the LSE in the early 1930s Hayek became almost instantaneously a well recognized figure in the economics profession, engaged in prominent controversies on economic theory with such opponents as J.M. Keynes and, on socialist calculation, with Oskar Lange and others. As his involvement in the latter debate induced the shift in his interest towards general issues of social and political philosophy, he increasingly removed himself from the standard professional discourse. He turned his attention to a fundamental critique of the philosophical foundations and the political implications of socialist doctrines, reflected most prominently in the publication of his most famous book *The Road to Serfdom* in 1944, a

book that quickly made him a widely known public figure, in particular in the United States, where a condensed version appeared in the *Reader's Digest* in 1945. While the book earned him public fame, it was met with considerable hostility among his colleagues in the economics profession many of whom were, at the time, much more inclined to interventionist views than to Hayek's classical liberal warnings against socialist concepts of social and economic planning. With the rise of Keynesianism in the 1950s and 1960s Hayek's work fell almost into oblivion, in academia as well as in public debate, and when in 1960 his major restatement of the principles of classical liberalism, *The Constitution of Liberty*, appeared, it was widely regarded, even by sympathetic observers, as an outdated treatise, out of step with modern economic and political thought. It came as a surprise to many, including Hayek himself, when in 1974 he was awarded the Nobel prize in economics. Even if the fact that he had to share the award with Gunnar Myrdal, an economist of quite different orientation, indicated significant ambivalence on part of the Nobel committee, the award was but an early indicator of a reawakening interest in classical liberal thought in general, and Hayek's work in particular, an interest that grew significantly in the later half of the 1970s, as a response to an increasing disillusionment with Keynesian economic policies and to accumulating evidence of the failure of "real socialism." In fact, Hayek became very much the symbol of what has been described as the "modern rebirth of classical liberalism." His work regained increasing attention in the academic community, his ideas influenced politicians like Margaret Thatcher and Ronald Reagan, and his publications found growing interest among dissidents and reformers in the disintegrating communist world. At age 90, Hayek witnessed the final collapse of the communist regimes in Europe as a conclusive confirmation of his lifelong critique of socialist constructivism.

In modern theoretical economics Hayekian ideas play an increasing role among a number of approaches that seek to advance an alternative theoretical outlook to the orthodox equilibrium paradigm. His ideas on the nature of human knowledge and learning are finding growing attention among scholars who seek a corrective for deficiencies of the traditional rational choice model. Recent developments in evolutionary economics, in the new institutional economics and in the economics of complex adaptive systems, either explicitly draw on, or give support to core ideas of his work, to his theory of the market as a spontaneous order, his outlook at competition as discovery process, and his evolutionary approach to institutions.

The reception of Hayek's work in social sciences other than economics is still in its infancy, yet his approach to social theory may well come to play a significant role as a paradigmatic contribution towards a theoretically integrated social science. One of Hayek's major concerns was that the disciplinary fragmentation of modern social science left what should be its central issue, namely "the problem of an appropriate social order" (1973: 4), without adequate attention. As he put it, even though the problem "is studied today from the different angles of economics, jurisprudence, political science, sociology, and ethics, the problem is one which can be approached successfully only as a whole" (ibid.). More than any of his contemporaries in the social sciences Hayek has made an effort in his own work to address the fundamental issue of an "appropriate social order" from a general social theoretical perspective that cuts across traditional disciplinary boundaries. With his ideas on the two kinds of social order, on the function of rules and institutions, and on cultural evolution he has made important steps towards a theoretically integrated social science.

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