

# 6

## *F. A. Hayek and the Spontaneous Order of the Market*

### **6.1. Biographical Introduction**

F.A. Hayek was one of the leading intellectual figures of the twentieth century. A multidisciplinary philosopher, great classical liberal thinker, and 1974 Nobel Prizewinner in Economics, Hayek produced a very extensive collection of works, which now exert a strong influence in the most varied spheres, in not only economics, but philosophy and politics as well. In fact, it has recently been asserted that in the history of economic, political, and social thought, the upcoming years could undoubtedly be described as the “Hayek era.”

Hayek was born May 8, 1899 into a family of academics and senior public officials, a family in which the intellectual, university life was highly valued. Nevertheless, the young Hayek was not a brilliant student: a lively, disorganized intellectual curiosity kept him from concentrating diligently on his different subjects. As Hayek himself confessed, if he took notes, he could not understand what he was listening to, and because he was unable to commit to memory the explanations of his professors, he was obliged to reproduce, *ex novo* and with great effort, any arguments he wished to present. As he indicates in his article “Two Types of Mind” (Hayek 1978c, 50-56), Hayek always attributed his fruitful intellectual ability precisely to the apparently disorganized and intuitive mental process that characterized him, a process that contrasted sharply with the minds of other Austrian theorists who, like Böhm-

Bawerk and Mises himself, had an absolute command of their subject and could present it orally and verbally with great rigor and clarity.

After World War I, when Hayek returned from the front (where he contracted malaria and learned some Italian), he entered the University of Vienna, which at the time was a hotbed of intellectual trends and discussions that was unrivalled the world over. (A rigorous analysis of the reasons behind this phenomenon in postwar Vienna has yet to appear.) For a while Hayek wondered if he should study psychology, and indeed, some years later he published a book on psychology entitled *The Sensory Order*, a very important work where he laid the foundations of his approach to epistemology (Hayek 1952). Nonetheless, Hayek eventually decided on legal and social sciences, and he specialized in economics under the tutelage of Friedrich von Wieser, who, as we have already mentioned, was perhaps the most confused and eclectic member of the second generation of the Austrian school of economics.

According to his own acknowledgement, Hayek's political views during these years did not differ significantly from those of his fellow students: he was a "Fabian" socialist who, following in the footsteps of his teacher, Wieser, believed the benign intervention of the state could improve the social order. It was not until he read *Socialism*, the critical analysis Mises published in 1922, that Hayek abandoned the socialist ideals he had embraced in his youth. At that point, a recommendation from Wieser enabled Hayek to begin his close collaboration with Mises in the professional sphere, first at the War Reparations Office, which Mises himself directed, and then as manager of the Austrian Institute for Business Cycle Research, which Mises had founded. In addition, in the academic sphere, Hayek became one of the most assiduous and productive participants in the seminar on economic theory which von Mises held

every two weeks in his office at the Vienna Chamber of Commerce, where he was general secretary.

We must emphasize that Hayek is indebted to Mises for the starting point of nearly all his work in economic theory.

It was thanks to Mises that Hayek abandoned much of Wieser's unhealthy influence and returned to the fundamentals of the Austrian conception of economics, which Menger had established, Böhm-Bawerk had enriched, and Mises himself had set out to support and defend from the follies of positivist theorists, like Schumpeter, and those more given to the equilibrium model, like Wieser. The relationship between Mises the teacher and Hayek the disciple was, nevertheless, curious to a certain extent. There was great admiration and respect, but the two also drifted apart at times, depending on the circumstances. It should be noted that Hayek showed a certain tendency to highlight his intellectual independence from a teacher whose theories, as Hayek himself recognized, were invariably supported in the long run by the very evolution of the real world.

In 1931, another disciple of Mises, Lionel Robbins, offered Hayek a professorship at the London School of Economics, a post he held until 1949. Thus Hayek became the leading exponent, in the English language, of the contributions of the Austrian school of economics. Hayek was always known to extend the utmost academic courtesy to all of his opponents, whom he never accused of bad faith, only of intellectual error. This was true, for example, of his debates with socialist theorists, with Keynes, and with Knight and the Chicago school, all of whom he opposed not only on issues of methodology (Hayek even stated that after Keynes's *General Theory*, the most dangerous book for economics was *Essays in Positive Economics*, by Milton Friedman), but also on the theory of money, capital, and cycles (Hayek 1994). Hayek

never uttered a word of complaint or reproach, not even when attacked furiously and unjustly by Keynes, nor when vetoed by members of the economics department at the University of Chicago, whose arrogance prevented them from accepting a “theorist of the Austrian school” into their ranks. (Fortunately, Hayek was accepted in the end – without an official salary, since a private foundation took care of paying him – into the Committee of Social Thought at this university, where he wrote his monumental work, *The Constitution of Liberty* [Hayek 1990a].)

Hayek was rather unlucky in his private life. In 1949, he destroyed his family when he decided to divorce his wife and marry an impossible love from his youth: a cousin of his who, through a misunderstanding, had married another man. Hayek bumped into her on a visit to his Viennese family following World War II, by which time she had become a widow. Hayek and his family paid a huge price for his decision. His English friends, led by Robbins, abandoned him, and the sorrow of the divorce appears to have cost his first wife her life (though this is a taboo subject about which Hayek and those closest to him never wished to speak). At any rate, he was not reconciled with Robbins until many years later, on the occasion of Hayek’s son Laurence’s wedding, and Hayek was obliged to spend the 1950s and part of the 60s in “exile” in the United States. Moreover, during these years, Hayek began to suffer from serious health problems: first, metabolic problems which left him extraordinarily weak and thin; then, increasing loss of hearing which made him a somewhat distant intellectual on a personal level; and finally, severe and recurrent bouts of depression which left him prostrate and intellectually unproductive for long periods of time. In fact, in the prologue to *Law, Legislation, and Liberty*, Hayek states that at times he even thought these ailments would prevent him from finishing the book (Hayek 1981). It is unknown to what extent Hayek’s harsh personal experiences reinforced his conviction

of the vital importance of moral behavior patterns in preserving human life on an individual and social level. However, the strong emphasis Hayek places on this topic in his works gives one the impression that this aspect of his thought was developed by someone who knew very well, from first-hand experience, what he was talking about.

All of the above health problems (physical and mental) disappeared almost miraculously when Hayek received the Nobel Prize in Economics in 1974, the year following the death of his teacher, Ludwig von Mises. At that point, Hayek felt himself coming out of his academic isolation, and he began a period of relentless activity during which he traveled all over the world presenting his ideas and managed to complete several more books. (The last of them, *The Fatal Conceit: The Errors of Socialism*, appeared when Hayek was almost ninety years old.) In fact, it can be asserted that the awarding of the Nobel Prize to Hayek in 1974 triggered the remarkable resurgence of the modern Austrian school of economics, a revival now taking place all over the world.

Hayek always wished to avoid involvement in politics. Furthermore, he considered the role of the intellectual, who must make scientific truth his chief goal in life, to be incompatible with the role of the politician, who is always obliged to yield to the dictates of public opinion to secure votes (Hayek 1991). Hence, Hayek believed that in the long term, efforts directed toward convincing intellectuals (thus his great success in founding the classical liberal Mont Pèlerin Society) or influencing public opinion would be much more productive. (Hayek dissuaded Anthony Fisher from entering politics and convinced him that it would be much more useful to create the Institute of Economic Affairs, and later the Atlas Research Foundation, to spread classical liberal ideas throughout the world.) So without the strategic initiatives Hayek took, it would have been impossible to conceive of the change in public opinion and in the intellectual sphere which led to the fall of the Berlin Wall and to the free-market/conservative

revolution that took place in the United States under Reagan and in England under Margaret Thatcher, a revolution which has exerted, and continues to exert, such a powerful influence on a worldwide scale.

Finally, it is perhaps fitting to close with a comment on Hayek's approach to religion. Christened Catholic, he abandoned religious practice at a young age and became an agnostic. Nonetheless, as the years passed, he gained an increasing understanding of, in general, the key role religion plays in structuring observance of the customs which form the basis of society, and in particular, the importance of the theologians of the Spanish Golden Age as forerunners of modern economic and social science. Moreover, in 1993, the Catholic thinker Michael Novak surprised the intellectual world when he made public the extensive personal conversation which took place between Pope John Paul II and Hayek before the latter passed away in 1992, so unmistakable signs indicate the marked influence Hayek's thought had on the encyclical letter, *Centesimus Annus*, particularly chapters 31 and 32, which are full of significant Hayekian contributions (Novak 1993a and 1993b). We will never know if Hayek, the professed agnostic, in the final moments of his life was able to take the necessary steps to comprehend and accept that supreme "anthropomorphic" being which far surpassed his powers of understanding. However, what we do know for sure is that Hayek comprehended better than anyone the risks of deifying human reason and the key role religion plays in avoiding them, to the point that, as Hayek writes in the final sentence of his final book, "on that question may rest the survival of our civilization" (Hayek 1990b).

## 6.2. Research on Economic Cycles: Intertemporal Discoordination

Hayek devoted the early decades of his academic work to the study of cycles. He followed Mises's theoretical lead, yet he made a number of his own very important contributions, and in fact, the Swedish Academy cited mainly the contributions Hayek made in the area of cycle theory during the 1930s as the reason he was awarded the Nobel Prize in 1974.

We should stress that when Hayek arrived in England in 1931, his analytical tools were far superior to those of his English colleagues in general, and to those of Keynes in particular. To begin with, Hayek had mastered Böhm-Bawerk's capital theory and understood perfectly why the supposed "paradox of thrift" was theoretically meaningless. Indeed, according to Böhm-Bawerk's theory, any increase in saving reduces consumption and thus tends to drive down the relative price of consumer goods. What Hayek termed the "Ricardo Effect" follows and consists of a rise in the demand for investment goods, which results from the increase in real wages, which in turn is caused, *ceteris paribus*, by any decrease in the price of consumer goods provoked by saving. This decrease in the price of consumer goods also leads to a relative increase in the entrepreneurial profits in the stages furthest from consumption, where products tend to rise in value in an environment of falling interest rates caused by the greater abundance of saving. The combined result of all of these factors is a lengthening of the productive structure, which becomes more capital-intensive, due to the financing which the larger quantity of real saved resources makes possible (Hayek 1995). The problem arises, according to Hayek, when monetary manipulation, in the form of credit expansion which the banking system brings about without the backing of prior saving, makes available to entrepreneurs new financial resources, which they devote to real investment as if society's saving had increased, when in fact this may not be the case.

The outcome is a lengthening of investment processes, a consequence of the artificial drop in the interest rate, which cannot be maintained over the long term. Therefore, Hayek concentrates on the variations which monetary growth induces in relative prices (specifically, in prices of the capital goods of different stages, and prices of consumer goods). The quantity theory of money, which focuses solely on the effects monetary variations exert on the general price level, tends to ignore and obscure the above phenomenon.

Moreover, Hayek realized that during the 1920s, the American Federal Reserve had deliberately initiated a policy of vigorous credit expansion aimed at neutralizing the “deflationary” effects of the substantial rise in productivity during those years. Thus, even though the prices of consumer goods and services did not climb significantly during this period, considerable monetary growth took place, and a large financial bubble formed. Sooner or later, this bubble would have to burst and expose the grave investment errors committed. In fact, Hayek states that *in an environment of falling prices created by a general rise in productivity, policies of monetary stabilization are bound to cause severe intertemporal discoordination between the decisions of investors and consumers, discoordination which sooner or later must reverse in the form of an economic recession*. Hayek expresses these ideas in his article on “Intertemporal Price Equilibrium and Movements in the Value of Money,” published in 1928 (Hayek 1984). The application of Hayek’s analysis to the existing circumstances enabled him to predict the Great Depression, which began in October 1929, and which Hayek always viewed as the result of the process of artificial credit expansion which the Federal Reserve had adopted on a massive scale during the preceding decade (Huerta de Soto 2006, 424-431).

Later, in 1931, Hayek published what would perhaps be his most important and well-known book in the area of cycle theory, *Prices and Production* (Hayek 1967). In this brief, crucial work, which has been translated into Spanish only recently, Hayek explains, in precise analytical detail, how credit expansion unbacked by a prior increase in voluntary saving distorts the productive structure, thus artificially making it too capital-intensive and requiring that the errors committed be revealed in the shape of a recession.

Indeed, for Hayek, monetary changes are never neutral and always exert a very harmful influence on the structure of relative prices. When new money is created in the form of credit, it always enters the economy at a specific point. Initially, money is spent on certain capital goods and productive services, and only afterward, slowly, do the effects spread throughout the rest of the productive structure. This means that some prices (those of the capital goods furthest from the final stage of consumption) will be affected before others (the prices of goods closest to consumption), and in this way the allocation of resources will change throughout the productive structure. In fact, the arrival of new fiduciary media created by the banking system means that some entrepreneurs who would have sustained losses make a profit, and many workers who would not have found work in certain sectors easily find a job in them.

The new money generally reaches the market following an artificial reduction in interest rates (below their “natural” level), as part of a policy of clear credit expansion and easy money. The relative drop in the discount rate and the easing of credit terms logically tend to increase investment spending in relation to consumer spending, thus distorting the indicators which guide entrepreneurs, especially the relative rate of return on capital invested in each of the stages or phases which, according to Austrians and as we know, comprise the productive structure.

As a consequence of the lower interest rates, investments appear profitable which before were not. The relative rise in investment expenditure, in turn, drives up the price of the productive factors, and hence entrepreneurs tend to adopt more capital-intensive production methods, and the demand for natural resources increases. At the same time, there is a decline in the relative profits of the consumer-goods industries, where costs gradually climb, yet prices do not. Thus begins a diversion of productive factors from the industries closest to consumption to the most capital-intensive sectors. This diversion must continue for a fairly prolonged period of time if the new, more capital-intensive productive structure recently embarked on is ever to come to fruition. Hayek stresses that when the utility of a machine depends on the production of other capital goods which are necessary for its use, then the machine becomes useless if, due to a lack of resources, these complementary goods are never produced.

Nevertheless, sooner or later, the new money the banking system has injected into the economic system starts to reach the pockets of factor owners, and this resulting increase in their monetary income begins to push up the demand for consumer goods. There is no reason to believe consumers will have appreciably modified the proportion in which, from the beginning, they have distributed their monetary income between present and future goods. Therefore, barring the hypothetical case in which economic agents save all the new money the banking system has created (a practically impossible event), there tends to be a widespread rise in the relative price of consumer goods, which follows: *a)* naturally from the arrival of new, liquid monetary assets to the consumer goods sector, where demand mounts as a result; and *b)* from the fact that the supply of consumer goods logically tends to fall temporarily, not only because resources are temporarily withdrawn from the sectors closest to consumption, but also because

many resources are devoted to investments which will only begin to bear fruit at the end of a lengthy period of time.

The increase in relative prices in the consumer goods sector provokes some effects which are the exact reverse of those credit expansion initially causes and we have described above: profits begin to grow in the industries closest to consumption and diminish, in relative terms, in investment sectors. The capital goods entrepreneurs began to produce with a very capitalistic productive structure in mind must be adapted if possible to a structure which is less so (and which, hence, is more labor-intensive, as is logical if we consider that a rise in the prices of consumer goods always entails a fall in real wages). Thus begins a generalized transfer of productive factors from investment to consumption, and heavy losses are incurred in the most capitalistic sectors (construction, shipyards, high-technology industries, computers and communications, etc.), which are only profitable at low interest rates, and which it now becomes clear were unduly expanded. In short, the arrival of an economic recession becomes inevitable, due to a lack of real resources sufficient to complete overly ambitious changes in the productive structure. These changes were undertaken in error, owing to the excessively easy financing which resulted from the artificial credit expansion the banking system initiated. The recession manifests itself outwardly in an excess of production in the investment sectors and a relative shortage of production in those sectors closest to consumption.

Hayek emphasizes that recessions are basically crises triggered by a relative excess of demand for consumer goods, or rather, a shortage of saving, i.e. saving insufficient to complete the more capital-intensive investments launched in error. The situation which arises from credit expansion resembles that of the imaginary inhabitants of a desert island who, having undertaken the construction of an enormous machine

capable of meeting all of their needs, exhaust their savings and capital before finishing it and have no choice but to abandon their project and devote all of their energy to the daily search for food, without the aid of any useful capital.

Therefore, the existence of “idle capacity” in many productive processes during the recession (but especially in those furthest from consumption, such as the construction, capital goods, telecommunications, or computer industries) in no way proves, according to Hayek, that an excess of capital exists or that consumption is insufficient. On the contrary, it is a sign that we cannot use all of the existing fixed capital, because the current demand for consumer goods is so urgent that we cannot allow ourselves the luxury of producing the circulating capital necessary to employ and take advantage of this idle capacity.

Hence, Hayek carries Böhm-Bawerk’s capital theory and Mises’s analysis of cycles to their logical conclusion when he describes how monetary interventionism occasions widespread intertemporal discoordination between the decisions of economic agents (investors and consumers) and explains that a recession is simply the stage of healthy economic readjustment. Hayek explains that this stage cannot be prevented, but that it can be facilitated by avoiding any subsequent credit expansion or artificial encouragement of consumption and permitting market forces to gradually establish a new productive structure more in keeping with the true desires of the economic agents who participate in it (Huerta de Soto 2006, 265-341).

The above is Hayek’s analysis on the theory of economic cycles, which he later completed in his work *Profits, Interest and Investment*, in which he assumes that unemployed factors of production exist (Hayek 1939). Hayek carried out and perfected this whole analysis bit by bit, in parallel with his debates with Keynes and the theorists

of the Chicago school on the theory of money, capital, and cycles. We will consider these controversies in the next section.

### **6.3. Debates with Keynes and the Chicago School**

It is not surprising that from the beginning, Hayek opposed the theorists of the neoclassical tradition who, due to their lack of a proper capital theory and to their inability to apply the theory of marginal utility to money, insisted on approaching the problems of the moment from an exclusively macroeconomic perspective.

Hayek voiced his radical objection to the quantity theory of money, held by neoclassical economists in general, and by the Chicago school in particular: “Given its macroeconomic nature, it focuses solely on the general price level and is inherently incapable of discovering the effects an expansion of the available means of payment exerts on the structure of relative prices. Therefore, it does not account for the gravest consequences of the inflationary process: the malinvestment of resources and the generation of the corresponding unemployment” (Hayek 1976a, 68-69).

In addition, Hayek revived the debate Böhm-Bawerk and Clark had engaged in on the concept of capital. In his work, *The Pure Theory of Capital* (Hayek 1976b), and his article on “The Mythology of Capital” (Hayek 1936, 199-228), Hayek criticizes the founder of the Chicago school, Frank Knight, for insisting on favoring the mythical conception of capital as a homogeneous fund which replicates itself, and for thus overlooking the structure of stages which constitutes the production process and eliminating the role of the entrepreneur in continually furthering the creation, coordination, and maintenance of these stages, or in deciding not to do so. According to Hayek, Knight’s approach is very dangerous, since his obsession with equilibrium ultimately leads him to defend the unsound theories of underconsumption and,

indirectly, the Keynesian prescriptions for artificially boosting effective demand, without considering the severe distorting effects of such action on the microeconomic structure of social production.

Nevertheless, the most significant debate was the one Hayek and Keynes took part in throughout the 1930s, which has only very recently been published in Spanish in its entirety (Hayek 1995). Hayek launched his criticism in two lengthy reviews of Keynes's book, *A Treatise on Money*, which appeared in England when Hayek had just arrived, at the start of the thirties. Keynes responded with a furious attack on Hayek's *Prices and Production*, and thus began a controversy between the two, in which some of the most important aspects of the theory of money and cycles were defined. Today, now that the Keynesian ship has run aground, we should pick up this debate where Keynes and Hayek left off at the end of the thirties. Specifically, Hayek criticized Keynes for his macroeconomic approach and his lack of a proper capital theory, one which depicts the productive structure as a set of stages, as Böhm-Bawerk had described it. Hayek also faults Keynes with swallowing the blatant myth of underconsumption, and in particular, with failing to comprehend that it is entirely possible to make money by producing a certain good even when the demand for it declines, provided one invests in lowering production costs by acquiring more capital goods, and hence generating a more capital-intensive productive structure. In this structure, in the stages furthest from consumption, employment is provided to the factors of production which are freed in the stages closest to consumption upon any rise in saving.

Moreover, Hayek views the Keynesian remedy for the Great Depression as nothing more than a temporary solution with adverse consequences. Indeed, any artificial rise in aggregate demand will severely distort the productive structure and can

only generate unstable employment. Furthermore, as it will become clear in the long term that labor has been devoted to unprofitable activities, even greater unemployment will result. According to Hayek, the fiscal and monetary manipulation Keynesians and monetarists prescribe causes serious distortions in the intertemporal coordination of the market. Therefore, Hayek is in favor of rigid monetary standards and against monetary nationalism and flexible exchange rates, which both Keynes and the Chicago school theorists so strongly supported. In another remarkable book, entitled *Monetary Nationalism and International Stability* (Hayek 1971), Hayek shows how flexible exchange rates provoke and foster grave real distortions in the productive structure, which lead inevitably to recessions that would not have occurred had fixed exchange rates been used. Hayek maintains that flexible exchange rates hinder the market in its coordinating role and generate unnecessary monetary distortions in the real process of resource allocation.

To illustrate for the reader the sharp differences in paradigm between Hayek's Austrian approach and the macroeconomic approach of Keynesians and monetarists, we now highlight these differences in Table 6.1.

Table 6.1  
Two Contrasting Approaches to Economics

<i>The Austrian School</i>	<i>The Neoclassical School (Monetarists and Keynesians)</i>
1. Time plays an essential role.	1. The influence of time is ignored.
2. “Capital” is viewed as a <i>heterogeneous</i> set of capital goods which receive constant wear and must be <i>replaced</i> .	2. Capital is viewed as a <i>homogeneous</i> fund which <i>reproduces</i> on its own.
3. The production process is <i>dynamic</i> and is <i>divided</i> into <i>multiple, vertical</i> stages.	3. There is a notion of a <i>one-dimensional, horizontal</i> productive structure in <i>equilibrium</i> ( <i>circular flow of income</i> ).
4. Money affects the process by modifying the structure of <i>relative</i> prices.	4. Money affects the <i>general</i> price level. Changes in relative prices are not considered.
5. Macroeconomic phenomena are explained in <i>microeconomic</i> terms (variations in relative prices).	5. <i>Macroeconomic aggregates</i> prevent the analysis of underlying microeconomic realities.
6. Austrians hold a theory on the institutional causes of economic crises which explains their <i>recurrent</i> nature.	6. A true theory of cycles is lacking. Crises have <i>exogenous</i> causes (psychological and/or errors in monetary policy).
7. Austrians hold an elaborate <i>capital theory</i> .	7. A theory of capital is lacking.
8. <i>Saving</i> plays a decisive role. It causes a <i>longitudinal</i> change in the productive structure and determines the sort of technology to be used.	8. <i>Saving is not</i> important. Capital is produced <i>laterally</i> (more of the same), and the <i>production function</i> is fixed and is determined by the state of technology.
9. There is an <i>inverse</i> relationship between the demand for capital goods and the demand for consumer goods. All investment requires saving and thus a temporary drop in consumption.	9. The demand for capital goods is <i>directly</i> related to the demand for consumer goods.
10. It is assumed that production costs are <i>subjective</i> and not predetermined.	10. Production costs are <i>objective</i> , real, and predetermined.
11. Market prices tend to determine production costs, not vice versa.	11. Historical costs of production tend to determine market prices.
12. The interest rate is a market price determined by subjective valuations of time preference. The interest rate is used to arrive at the present value toward which the market price of each capital good tends. To obtain the present value of a capital good, its expected future flow of returns is discounted by the interest rate. Fractional-reserve banking and central banks’ manipulation of the interest rate give rise to recurrent cycles of boom (artificial) and recession.	12. The interest rate tends to be determined by the marginal productivity or efficiency of capital, understood as the internal rate of discount at which the expected flow of returns is equal to the historical cost of producing the capital goods (which is considered predetermined and invariable). The interest rate is believed to be a predominantly monetary phenomenon in the short term.

#### 6.4. The Debate with the Socialists and Criticism of Social Engineering

Beginning with his 1935 publication of a collection of essays on the logical impossibility of socialism, entitled *Collectivist Economic Planning* (Hayek 1975), Hayek assiduously and loyally participated alongside Mises in the debate on the impossibility of socialist economic calculation, with a series of essays and papers which, fortunately, have just been published all together in Spanish (Hayek 1997). Hayek's fundamental idea, which inspired the title of the last book he wrote, *The Fatal Conceit*, is that socialism constitutes a fatal error of intellectual pride, or scientific arrogance. In his writings, Hayek uses the term "socialism" in a very broad sense, which encompasses not only so-called "real socialism" (that is, the system based on public ownership of the means of production), but in general, any systematic attempt, via coercive "social engineering" measures, to partially or totally design or organize any sphere of the network of human interactions which make up the market and society. Hayek holds that socialism, in this broad sense of the term, is an intellectual error, since it is logically *impossible* for someone with a wish to organize or intervene in society to generate or obtain the information or knowledge that would allow him to fulfill his voluntaristic desire to "improve" the social order. In fact, according to Hayek, society is not a system which is "rationally organized" by a human mind or group of minds, but on the contrary, it is a *spontaneous order*, i.e. a dynamic process which is constantly evolving and emerges from the continuous interaction between millions of human beings, but which has not been, nor ever can be, consciously or deliberately designed by any man.

The essence of the social process, as Hayek understands it, lies in the (as we saw in chapter 2) strictly personal, subjective, practical, and dispersed information or knowledge which every person, in his particular circumstances of time and place,

gradually discovers and generates with each one of the human actions he undertakes in order to achieve his particular ends and objectives, actions which are embodied in the stages of that fascinating journey that is every human life. For people to be able to entrepreneurially discover and transmit the huge volume of practical information or knowledge which the advancement and preservation of today's civilization require, it must be possible for them to freely conceive ends and discover the means necessary to accomplish them, without any sort of hindrance, especially systematic or institutional coercion or force. Thus, the sense in which Hayek views socialism, regardless of its type or degree, as an *intellectual error* is obvious. On the one hand, a person who seeks to "improve" or organize a certain sphere of social life using institutional coercion will lack the enormous volume of practical, dispersed information that is spread throughout the minds of the thousands of individuals who must suffer his orders. (This lack will be due to his capacity for comprehension, as well as to the volume, and especially the tacit, inarticulate, and dynamic nature, of the type of practical knowledge that is vital to life in society.) On the other hand, the systematic use of coercion and violence, which are the essence of socialism, will prevent people from freely pursuing their ends, and hence, will also prevent these ends from acting as an *incentive* for people to discover and generate the practical information necessary for the advancement and coordination of society.

Hayek maintains that the very reasons socialism is an intellectual error and a logical impossibility also account for the fact that the institutions which are most important to life in society (moral, legal, linguistic, and economic institutions) could not have been deliberately created by anyone and are the result of a long evolutionary process in which millions and millions of human beings from successive generations have each made a tiny contribution of experiences, desires, longings, knowledge, etc.,

and have thus given rise to a number of repetitive behavioral norms (institutions) which emerge from the process of social interaction while at the same time making this process possible. These repetitive behavioral norms or material rules of conduct constitute an *intermediate realm* between biological instinct, which affects us all, and the explicit sphere of human reason. It is an intermediate realm, because while such norms undoubtedly arise from human action, they incorporate such a large volume of information, experiences, and knowledge, that they far exceed the capacity of any one human's mind or reason, which thus is incapable of creating, conceiving, or designing this sort of institution *ex novo*.

The rules of conduct which permit the emergence of civilization appear in an evolutionary process, during which those social groups that first develop the framework of norms and behaviors characteristic of peaceful, voluntary trade (the framework of rules and institutions which comprise property law) gradually absorb and prevail over other human groups that are comparatively more backward, due to their more primitive or tribal structure. Hence, as Hayek indicates, socialists are gravely mistaken in believing that the emotions and attitudes typical of small, primitive groups (based on the principles of solidarity, altruism, and loyalty) can be sufficient to maintain the *extensive order of social cooperation* which constitutes modern society. Indeed, the principles of solidarity and altruism can be applied in primitive groups, precisely because in this type of group the needs and characteristics of each member are intimately known. However, to try to extrapolate the principles of solidarity and altruism, which are typical of a tribal group, to the extensive order of social cooperation, in which millions of individuals interact and cooperate, individuals who do not know each other nor ever will, would only bring about the disappearance of civilization, the physical elimination of most of the human race, and a return to a tribal, subsistence economy.

Hayek's new contribution consisted chiefly of having shown that Ludwig von Mises's original idea concerning the impossibility of socialist economic calculation is merely a specific application of the more general principle of the logical impossibility of social engineering, or "constructivist" or "Cartesian" rationalism. As this type of rationalism rests on the illusion that human reason is far more powerful than is actually the case, it reflects the fatal "scientistic" conceit that involves envisioning no limits to the future applications of technique or social engineering. Hayek uses the term "scientism" to refer to the unjustified application to the social sciences of the method typical of physics and the natural sciences, and during the 1940s and early 1950s, he wrote a number of articles which later, in 1955, appeared in book form under the title, *The Counter-Revolution of Science* (Hayek 1955). In this book, Hayek carries out a devastating critical analysis of the positivist rationalism rooted in Comte and Saint-Simon, as well as of the narrow, Benthamite utilitarianism which presupposes an environment in which information about the benefits and costs of every action is known and permits the making of maximizing decisions. Unfortunately, this period also saw the publication of Milton Friedman's work, *Essays in Positive Economics* (Friedman 1967), which achieved great popularity and gave fresh impetus to the use of positivist methodology in our science. Although Hayek's book largely anticipated, answered, and criticized the most salient points presented in Friedman's almost contemporary book, Hayek himself later came to state: "You know, one of the things I often have publicly said is that one of the things I most regret is not having returned to a criticism of Keynes's treatise [*The General Theory*], but it is as much true of not having criticized Milton's *Essays in Positive Economics*, which in a way is quite as dangerous a book" (Hayek 1994, 145). The above comment may surprise those who identify Hayek with the liberalism of the Chicago school without perceiving the very profound

methodological differences between members of this school and Austrian theorists. Elsewhere, Hayek himself offered further clarification of these methodological differences with Friedman and the neoclassicals. He stated: “Friedman is an arch-positivist who believes nothing must enter scientific argument except what is empirically proven. My argument is that we know so much detail about economics, our task is to put our knowledge in order. We hardly need any new information. Our great difficulty is digesting what we already know. We don’t get much wiser by statistical information except by gaining information about the specific situation at the moment. But theoretically I don’t think statistical studies get us anywhere ... Milton’s monetarism and Keynesianism have more in common with each other than I have with either ... The Chicago School thinks essentially in ‘macroeconomic’ terms. They try to analyze in terms of aggregates and averages, total quantity of money, total price level, total employment, all these statistical magnitudes ... Take Friedman’s ‘quantity theory.’ I wrote forty years ago that I have strong objections against the quantity theory because it is a very crude approach that leaves out a great many things. I regret that a man of the sophistication of Milton Friedman does not use it as a first approach but believes it is the whole thing. So it is really on methodological issues, ultimately, that we differ” (Hayek 1993, 129-130).

Finally, we should remember that Hayek’s critical analysis of equilibrium economics began with two seminal articles published in the 1930s and 1940s, and entitled *Economics and Knowledge* (1937) and *The Use of Knowledge in Society* (1945). In these papers, Hayek articulates the conclusion he reached in his debate with the socialist neoclassical theorists, i.e. that they were unable to fathom the impossibility of socialism because the models of general equilibrium they depended on assumed that all the necessary information about the variables and parameters of the simultaneous

equations which comprised equilibrium was already “given.” Hayek reveals that, contrary to this assumption of economic equilibrium theory, in real life such information is never given, but instead entrepreneurs discover and create it step by step through a dynamic process which should be economists’ object of study. Thus, Hayek naturally abandons the neoclassical concept of perfect competition and proposes, following in the Austrian tradition (of scholastic origin), a dynamic model of competition understood as a process of information discovery. He expresses this idea in two important papers: *The Meaning of Competition* (1946) and *Competition as a Discovery Procedure* (1968) (Hayek 1948, 57-106; 1978a, 179-190; 1981).

### **6.5. Law, Legislation, and Liberty**

The year 1949, in which Hayek left the London School of Economics and moved to the University of Chicago, marked a substantial change in his research program. Indeed, Hayek began at that time to devote himself principally to the study of the legal and institutional factors conducive to a free society, and hence he shifted his main focus away from economic theory. Hayek lost interest in the direction theoretical discussion took in the 1950s and 1960s regarding the macroeconomic concepts which grew out of the “Keynesian revolution,” and he decided to wait until the storm of scientism passed and meanwhile to proceed with research Carl Menger had initiated, concerning the emergence and evolution of institutions. Hayek’s efforts over the three decades that followed yielded two works of prime importance: *The Constitution of Liberty* (1990a) and the trilogy *Law, Legislation, and Liberty* (1978, 1981).

It would be impossible to present here all of Hayek’s contributions to the field of legal and political theory; in Spain, however, distinguished commentators on Hayek’s work have already performed the task (De la Nuez 1994). Here we can only point out

the existence of an obvious, logical relationship and unity between the contributions Hayek made in the area of economic theory and those he made in the area of legal and political theory. In fact, in Hayek's view, as socialism rests on a systematic, institutionalized assault on human action, an assault committed via a series of *coercive orders or commands*, it entails the disappearance of the traditional concept of *law*, understood as a set of rules which are both *general* (equally applicable to everyone) and *abstract* (since they merely establish a broad framework for individual action, without predicting any concrete result of the social process). In this way, material laws are replaced by spurious "law," which consists of a conglomeration of administrative orders, regulations, and commands which specify exactly how each human being is to behave. So to the extent that economic interventionism spreads and develops, traditional laws cease to act as standards for individual behavior, and the role of these laws is taken over by the coercive orders or commands which emanate from the governing body (whether democratically elected or not) and which Hayek calls "legislation," as opposed to the general concept of "law." The law thus loses its scope of practical implementation and becomes confined to those areas, be they regulated or not, which do not effectively fall under the direct influence of the interventionist regime.

Moreover, a highly significant secondary consequence ensues: as actors are deprived of the reference point material law provides, they gradually modify their personalities and lose the custom of adapting to abstract, general norms. As a result, they assimilate and adhere to traditional rules of conduct less and less. Furthermore, since the evasion of commands is in many instances actually a question of survival, and in others it reflects the success of the corrupt entrepreneurship socialism tends to provoke, most people come to see a disregard for the rules as an admirable expression

of human ingenuity (to be sought and promoted), rather than a violation of a system of norms the infringement of which jeopardizes life in society. In short, socialism encourages people to break the law, empties it of its content, and corrupts it, thus completely discrediting the law on a social level and causing citizens to lose all respect for it.

According to Hayek, this prostitution of the concept of law is invariably accompanied by a parallel prostitution of the concept and application of *justice*. Justice, in the traditional sense, consists of the equal application to all people of the abstract, material rules of behavior which comprise private law and criminal law. Hence, it is no coincidence that justice has been depicted blindfolded, since justice must above all be *blind*, in that it must not “show partiality to the poor or favoritism to the great” (Lev. 19:15, New International Version) in its application of the law. Because socialism systematically corrupts the traditional concept of law, it also alters this traditional conception of justice. Indeed, in the socialist system, “justice” consists chiefly of arbitrary assessments, made by the governing body or individual judges, based on their more or less emotional impression of the concrete “final result” of the particular social process which they believe they perceive at a given moment and which they boldly attempt to organize from above via coercive commands. Therefore, it is no longer human behaviors which are judged, but rather the perceived “result” of them within a spurious context of “justice,” to which the adjective “social” is added to make it more attractive to those who suffer it. From the opposite perspective of traditional law, *there is nothing more unjust than the concept of social justice*, because it rests on a view, impression, or assessment of the “results” of social processes, regardless of the particular behavior of each individual actor from the standpoint of traditional-law rules.

Hayek asserts that in traditional law, judges fulfill a merely intellectual function; they must not allow themselves to be influenced by their emotional inclinations nor by their personal estimations of the consequences a judgment will have for each party. If, as occurs in socialist systems, the objective application of the law is prevented and the issuing of legal rulings based on more or less subjective and emotional impressions is permitted, all legal certainty disappears and actors soon become aware that any claim may obtain judicial protection if only a favorable impression can be left on a judge. This creates a major incentive to litigate, which together with the chaotic situation that arises from a tangled web of coercive and increasingly flawed and contradictory commands, overburdens judges to such an extent that their job becomes more and more unbearable and inefficient. This progressive breakdown ends only with the virtual disappearance of traditional justice and of judges as well, who become mere bureaucrats, subordinate to the political authorities and responsible for monitoring compliance with their coercive commands. Table 6.2 systematically outlines the key differences between the spontaneous process based on entrepreneurship and free human interaction, and the organizational system built on commands and institutional coercion. The table focuses on the contrasting effects which, according to Hayek, these two approaches have on the concepts and application of law and justice.

**Table 6.2**

<p><i>SPONTANEOUS SOCIAL PROCESS</i> Based on entrepreneurship (Unassaulted social interaction)</p>	<p><i>SOCIALISM</i> (Systematic institutional aggression against entrepreneurship and human action)</p>
<p>1. Social coordination occurs spontaneously, due to entrepreneurship, which constantly discovers and eliminates social maladjustments, which emerge as profit opportunities. (Spontaneous order)</p>	<p>1. Attempts are made to deliberately impose social coordination from above via <i>coercive commands, orders, and regulations</i> which emanate from the authorities. (An organized hierarchy – from <i>hieros</i>, sacred, and <i>archein</i>, to command)</p>
<p>2. The protagonist of the process is <i>man</i>, who acts and exercises creative entrepreneurship.</p>	<p>2. The protagonists of the process are the <i>leader</i> (democratic or not) and the <i>public official</i> (that person who acts in compliance with the administrative orders and regulations which emanate from the authorities).</p>
<p>3. The links of social interaction are <i>contractual</i>, and the parties involved exchange goods and services according to material legal rules. (Law)</p>	<p>3. The links of social interaction are <i>hegemonic</i>; some people command and others obey. In a “social democracy,” the “majority” coerces the “minority.”</p>
<p>4. <i>The traditional, material concept of law, understood as an abstract, general rule</i> predominates and is applied equally to all regardless of particular circumstances.</p>	<p>4. <i>Commands and regulations</i> predominate and, notwithstanding their appearance as formal laws, are specific, concrete orders which command people to do certain things in particular circumstances and are not applied equally to all.</p>
<p>5. The laws and institutions which make the social process possible have not been deliberately created, but have <i>evolved</i> from <i>custom</i>, and they incorporate an enormous volume of practical experience and information which has accumulated over many generations.</p>	<p>5. Commands and regulations are deliberately issued by the <i>organized authorities</i> and are highly imperfect and unsound, given the ineradicable ignorance in which the authorities are always immersed with respect to civil society.</p>
<p>6. The spontaneous process makes <i>social peace</i> possible, since each actor, within the framework of the law, takes advantage of his practical knowledge and <i>pursues his own particular ends</i> through pacific cooperation with others and by spontaneously adapting his behavior to that of others who pursue different goals.</p>	<p>6. One end or set of ends must <i>predominate</i> and be imposed on all through a system of commands. This results in irresolvable and interminable social conflict and violence, which obstruct social peace.</p>
<p>7. <i>Freedom</i> is understood as the absence of coercion or aggression (both institutional and asystematic).</p>	<p>7. “Freedom” is understood as the ability to achieve the specific ends desired at any moment (through a simple act of will, a command, or caprice).</p>
<p>8. The traditional meaning of <i>justice</i></p>	<p>8. The spurious sense of “justice of the</p>