

Mises, the great system builder, provided Hayek with a program for the study of the economic system and the defense of classical liberalism. Hayek is the great dissector and analyzer of the Misesian system. His work can be best understood as the continued attempt to make explicit what Mises left implicit, to refine what Mises stated explicitly, and, to answer questions Mises left unanswered. As Hayek has said of Mises, "There is no single man to whom I owe more intellectually, even though he was never my teacher in the institutional sense of the word" (*Knowledge, Evolution and Society*, Adam Smith Institute, 1983, p. 17). This influence is most apparent in Hayek's work on knowledge and the analysis of socialism, but these insights on knowledge dispersion and conveyance are inseparable from the rest of Hayek's analyses, from business cycles to common law.

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### Intellectual Development

F. A. Hayek was born on May 9, 1899 in Vienna into a family of intellectuals. Hayek's grandfather was a biologist who studied zoology; his father was a medical doctor who conducted research in botany; his mother's father was a professor of constitutional law and statistics; one of his brothers became a professor of anatomy, while another became a professor of chemistry. It is no wonder that much of his subsequent research would cross disciplinary boundaries and attempt to integrate insights from biology, law, and psychology into his work of political economy.

Hayek earned two doctorates from the University of Vienna (1921 and 1923). At the University, Hayek was a pupil of Freidrich von Wieser, who, along with Carl Menger and Eugen von Boehm-Bawerk, was a representative of the first generation of Austrian economists. Hayek recalls that he was attracted to Wieser because "he had a good deal of sympathy with a mild Fabian socialism to which I was inclined as a young man" (*ibid.*). After his university studies, Hayek was introduced to Mises through Wieser, and their collaboration began. For five years, Hayek worked under Mises at a government office, and then, in 1927, they co-founded the Austrian Institute for Business Cycle Research.

Mises' book, *Socialism*, which was published in 1922, had a profound effect on Hayek's thinking. As Hayek, in the foreword of the Liberty Press edition of *Socialism* (1981), describes it, the book's publication had a lasting impact on a whole generation of economists. He states:

## Economists and Liberty:

### F.A. Hayek (1899-)

by Peter Boettke

F. A. Hayek, the 1974 Nobel Laureate in Economic Science, is one of the most prolific scholars of this century. He has published articles and books on topics ranging from theoretical psychology to technical economics, from political philosophy to legal anthropology, and from the philosophy of the social sciences to the history of ideas. In addition to his scholarly activities, Hayek has found time throughout his career to be an intellectual activist for political and economic freedom. He co-founded, and was long associated with, the Mont Pelerin Society, perhaps the largest intellectual organization devoted to the advancement of classical liberalism. Hayek, at the age of 88, is still learning and writing about the nature of the private property order and the failure of socialism and interventionism—his latest book, *The Fatal Conceit*, is now at press. History will surely remember Hayek as one of the major defenders of the classical liberal ideas of political and economic freedom in the 20th century.

Hayek's life-work, though, comes to us in scattered concentrations on various topics. This has resulted in some scholars, such as T. W. Hutchison, postulating a fundamental dichotomy in Hayek's thought—a Hayek I, who is under the influence of Mises, and a Hayek II, who rejects the methodology of Mises and embraces Karl Popper's views on the philosophy of the social sciences (c.f., *The Politics and Philosophy of Economics*, New York University Press, 1984, pp. 176-232). John Gray, in his excellent book, *Hayek on Liberty* (Basil Blackwell, 1986), has argued that this dichotomy does not exist and that there is a fundamental unity in Hayek's thought that centers on his Kantian epistemology. While Gray's interpretation of Hayek is essentially correct, I believe that it is more accurate to understand Hayek's contribution to economics and classical liberalism in terms of the research program laid out by Mises.

"We felt, that the civilization in which we had grown up had collapsed. We were determined to build a better world, and it was this desire to reconstruct society that led many of us to the study of economics. Socialism promised to fulfill our hopes for a more rational, more just world. And then came this book. Our hopes were dashed. *Socialism* told us that we had been looking for improvement in the wrong direction" (Liberty Press, 1981, p. xix).

The problem confronting socialism was and is its technical impossibility. The knowledge necessary to centrally plan an advanced industrial economy is not available to any one mind or group of minds. This insight into the division of knowledge within society is the most fundamental aspect of Hayek's thought—both in terms of his positive claim of the spontaneous ordering of the market society and the negative claims of impossibility of socialism and the undesirability of interventionism. The market is a means by which the dispersed bits and pieces of local knowledge are conveyed. Economics, to Hayek, studies how it is that the price system utilizes this scattered knowledge in order to coordinate economic decision about the allocation of scarce resources among the various and competing ends. (c.f., Gerald O'Driscoll, *Economics as a Coordination Problem*, Sheed, Andrews and McMeel, 1977). Any successful inquiry into alternative economic systems or economic policy reforms must deal with the fundamental question of how, what, and for whom. This question of coordination pervades all of Hayek's writings on technical economics and political economy. He grapples with the question by explaining the use of knowledge in society.

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### Knowledge in Society

John Gray has located this emphasis on the limits of rationality in Hayek's earliest research. Before Hayek decided to study economics, his interests lay in theoretical psychology. At the age of 21, he wrote the manuscript of what was later revised and published as *The Sensory Order* (Chicago University Press, 1976 [1952]), which investigates the workings of the brain. But, as Hayek states in the preface, "though my work has led me away from psychology, the basic idea then conceived has continued to occupy me; its outlines have gradually developed, and it has often proved helpful in dealing

with the problems of the methods of the social sciences" (p. v). The book's concern is with the way in which the human mind processes and organizes the objects that confront it in the material world. It is a difficult book, but for those interested in understanding Hayek's thought, it is crucial to understand its basic message.

Brute facts do not confront the human mind directly, Hayek argues. The mind is incapable of knowing objective reality in concrete detail. Rather, the mind organizes and filters physical reality through abstract concepts. "All we can hope to do," Hayek states, "is to aim at an explanation of the principle" (p.193). The implication of this for human inquiry is

"The recognition of the fact that for our understanding of human action familiar mental entities must always remain the last determinants to which we can penetrate, and that we cannot hope to replace them by physical facts, is, of course, of the greatest importance for all the disciplines which aim at an understanding and interpretation of human action. It means, in particular, that the devices developed by the natural sciences for the special purpose of replacing a description of the world in sensory or phenomenal terms by one in physical terms lose their *raison d'être* in the study of intelligible human action. This applies particularly to the endeavor to replace all qualitative statements by quantitative expressions or by descriptions which run exclusively in terms of explicit relations" (ibid.).

This argument is identical to those of Mises when he argues that the ultimate given in the human sciences is that man acts purposively, or that the human sciences begin with reflection upon the essence of human action, or that the human sciences possess "knowledge from within" because we are what we study. The fact that the scientist is part of the phenomena under investigation puts a limit on the use scientific methods, like positivistic testing or formalistic models, but not of scientific inquiry. The human sciences have an advantage over the physical sciences precisely because we understand through introspection that man has goals and strives to attain these goals. The implications of this view are vast and lead to the unique understanding of market processes that is the backbone of Austrian analysis.

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The market, from this perspective, is understood as the interaction of human minds where the price system, through the interaction of subjective suppliers and demanders, brings the various minds into coordination with one another. As Mises has described this operation:

"The process, by which supply and demand are accommodated to each other until a position of equilibrium is established and both are brought into quantitative and qualitative coincidence, is the haggling of the market. *But supply and demand are only the links in a chain of phenomena, one end of which has this visible manifestation in the market, while the other is anchored deep in the human mind*" (*Theory of Money and Credit*, Liberty Press, 1980, p. 153, emphasis added).

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It has been Hayek's great contribution to economics, and to our understanding of the liberal economic order, that he has looked deeply into the chain of phenomena that makes up the market process and provided insights into how the knowledge necessary to coordinate suppliers with demanders is conveyed through the price system. Market participants do not possess knowledge of the "real underlying factors" in the economic system, instead they rely on money prices to inform them about the relative scarcities of various goods. The marvel of the market is that the price system, through increases or decreases in the relative price of goods, produces informational signals about scarce resources so "tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly [abundantly]; that is, they move in the right direction" (c.f., Hayek, *Individualism and Economic Order*, University of Chicago Press, 1980[1948], p. 87).

Gray, therefore, is correct in concentrating on *The Sensory Order* to get at Hayek's philosophical predirection, but I think he underestimates the impact of Mises on the set of questions which Hayek considers important. Hayek is dealing with economics as a coordination problem and the implications of this view of economics for socio-political organization. Before him are three questions: (1) what causes the malcoordination of plans that occur in business cycles, (2) can a socialist economic order coordinate production plans in a more rational manner than capitalism, and (3) how does the liberal economic and political order work?

Hayek's association with Mises naturally led him to deal with problems in monetary and trade cycle theory. Their work at the Austrian Institute for Business Cycle Research resulted in the Mises-Hayek theory of the trade cycle. Building upon Mises' *Theory of Money and Credit*, Hayek refined both the technical understanding of capital coordination and the institutional details of credit policy. His first two books, *Monetary Theory and the Trade Cycle* (1929), and *Prices and Production* (1931), analyzed the effects of credit expansion on the capital structure of an economy. *Prices and Production* was a series of lectures that Hayek gave on a visit to the London School of Economics. These lectures were received with great acclaim and as a result Hayek was appointed the Tooke Professor of Economics Science and Statistics at London University. Hayek's theory of the trade cycle attempted to render intelligible the "cluster of errors" that occurs during the bust. Hayek, following Mises, explained this in terms of the "false" signal conveyed to businessmen through credit manipulation. By artificial lowering of the interest rate, businessmen are led to believe that the amount of real savings is greater than what it actually is, and, as a result, they engage in investment projects that otherwise would not have appeared profitable. This leads to intertemporal malcoordination, which first manifests itself in the boom, and then, later, in the bust, as the time pattern of production adjusts to the amount of real savings and consumers assert their preferred pattern of consumption. Applying this theory to the U.S. economy of the 1920's, Hayek "predicted," in February 1929, that a crisis and downturn in the U.S. was imminent (c.f., Fritz Machlup, "Hayek's Contribution to Economics," *Swedish Journal of Economics*, December 1974, Vol. 76, pp. 498-531).

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Hayek's arrival in London sparked off perhaps the most fundamental debate in monetary policy in the 20th century—the Hayek-Keynes debate. Keynes had published *A Treatise on Money* in 1930 and Hayek wrote a lengthy and critical review (c.f., "Reflections on the Pure Theory of Money of Mr. J. M. Keynes," *Economica*, August 1931, and February 1932). The main problem with Keynes was his failure to understand the role that the interest rate and the capital structure play in the intertemporal coordination of plans in a market society. Keynes responded to the first part of Hayek's critique by attacking *Prices and Production*. After the second part



of Hayek's critique was published, Keynes, essentially, responded to Hayek by conceding the debate—he changed his mind and did not believe what he wrote in the Treatise anymore.

Keynes then turned his mind to *The General Theory*. Hayek, on the other hand, began refining his understanding of capital theory—he was convinced that this was the key point to convey to Keynes and the rest of the economics profession. *The General Theory* was published in 1936, and Hayek decided not to respond to it because of his earlier experience. By not responding, Hayek committed what many defenders of the free-market system consider to be one of the major tactical errors of this century. While Keynes' *General Theory* became perhaps the most influential book on economic policy in the 20th century, Hayek labored with *The Pure Theory of Capital* (University of Chicago Press, 1975[1941]), which is his most technical and least influential book. Keynes won the debate and eventually won over Hayek's students. But there was one other debate in which Hayek had to engage, and this time it was with explicit socialists.

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### The Fatal Conceit

The socialist calculation debate was triggered by Mises' 1920 article which stated that socialism was technically impossible. In 1922, Mises later refined this argument in his book *Socialism*. Through a series of articles in the 1930's and 1940's, Hayek defended Mises' contention and further developed the argument against socialist planning. In 1935, Hayek collected and edited a series of essays on the problems of socialist economic organization (c.f., *Collectivist Economic Planning*, Augustus M. Kelley, 1975). The collection contains a translation of Mises' original article as well as articles by other earlier writers on the subject. In addition, Hayek wrote a long introductory essay on the history of the debate and a concluding essay summarizing the current status of the debate. Additional Hayek essays on the technical economic problems of socialism can also be found in *Individualism and Economic Order*.

This concern with the problems of socialism and its impact on liberal society led Hayek to write what is perhaps his most famous book, *The Road to Serfdom* (University of Chicago Press, 1976[1964]). The fatal flaw of socialism, as discussed above, is that in the absence of the price system, there is no way that the central planning bureau would know which production possibilities are economically feasible and which ones are not. The rationalistic belief that society is a product of our conscious design and therefore, that through con-

scious control and design we can improve the social order, which underlies socialist and interventionist thinking, is what Hayek has recently referred to as the fatal conceit.

*The Road to Serfdom*, however, forces advocates of socialism to confront the other problem that any attempt to implement socialism must overcome—the totalitarian problem. If socialism requires the replacement of the market with a central plan, an institution must be established that is responsible for formulating the plan. That institution is the Central Planning Bureau. In order to implement the plan, this bureau must be granted discretionary power in economic affairs. Hayek gives us good reasons to suspect "Why the Worst Get on Top." We would expect that those who have a comparative advantage in exercising discretionary power would rise to the top and run the institutions which are granted this power, using them to their advantage.

This has historically been the case and it is not limited to the personalities of Stalin, Hitler, and Mao, whose cultural experiments resulted in some 37 million dead (a modest estimate). Lord Acton is famous for the dictum, "Power tends to corrupt, and absolute power tends to corrupt absolutely," and it seems he was right after all. The question which socialists must face, a question Hayek posed in a most gentle manner, is, given their goal of emancipating man from oppression, how can socialism achieve its goal when the very institutions which it must advocate to eliminate market relations lead to the oppression and death of millions? Modern socialists must either (1) turn their backs on the horrors of 20th century socialism; (2) come up with a coherent alternative to central planning that still eliminates the market; or (3) give up the vision of socialism as the promise of emancipation and embrace an alternative vision of the way the world could be. Given both the knowledge problem associated with attempts to replace or control the market and the totalitarian problem associated with placing discretionary power in the hands of a few, it seems high time that the left recognize the radicalism of a truly free market, and that libertarians communicate to the left our vision of what the world could be—a vision of the world in the absence of state oppression and violence. Hayek has done much to aid us in this endeavor.

### The Liberal Order

Hayek, perhaps more than any other figure in intellectual history, has concentrated his efforts on elaborating the operation of the spontaneous ordering of economic and social activities. His understanding of the price system as a conveyor of knowledge is just one example. His more recent work has concentrated on the spontaneous emergence of the legal and moral order (c.f., *Law, Legislation and Liberty*, 3 vols., University of Chicago Press, 1973, 1976, 1979 and *The Fatal Conceit*, Vol. I, Routledge & Kegan Paul, 1988).

After his defeat to Keynes and the confusion of the socialist calculation debate, Hayek turned his attention to writing about a positive program for classical liberalism. He moved to the University of Chicago in 1950, where he taught in the Committee on Social Thought until 1962, when he obtained a post as Professor of Economic Policy at the University of Freiburg. During his stay at the University of Chicago (which I understand was similar to Mises' position at New York University in that neither had a university appointment but taught as a visiting professor and was paid through private foundations), Hayek worked on *The Constitution of Liberty*. Many consider this to be his magnum opus, but given the subsequent publication of *Law, Legislation and Liberty* I think it is better to view the book as his first attempt at a restatement of the foundations of classical liberalism. Hayek is one of those rare scholars who continues to learn even in his elderly years and, therefore, his final statement on liberalism is still forthcoming. In both *The Constitution of Liberty* and *Law, Legislation & Liberty*, Hayek emphasizes the rule of law as the necessary foundation for the liberal order.

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His basic insight is that law, like the market, is a spontaneous order—the result of human action, but not of human design. Law emerges in a case by case fashion where judges apply general traditions, themselves the product of cultural evolution, to particular cases. Hayek's analysis in this sense is very similar to that of Bruno Leoni's *Freedom and the Law* (Nash Publishing, 1972) or the more recent historical discussion of the formation of the Western legal tradition found in Harold Berman's *Law and Revolution* (Harvard University Press, 1983). Since law, like money and markets, emerges through the voluntary interaction of human beings, though no one of them consciously designed it, the State's influence in these matters (1) was not necessary for either law or markets to emerge and (2) has corrupted the institutions of law and money. Thus, much of Hayek's work on law and the liberal order is an analysis of the tradition of common law in contrast to legislative decree.

While Hayek has recently advocated competing currencies to combat the corrupting influence of the state in monetary affairs (c.f., *Denationalization of Money*, Institute for Economic Affairs, 1978), he has not advocated such radical policies for legal reform. Instead of advocating open competition in the production of legal services, Hayek offers constitutional constraints within a representative democracy on legislative activity. But Hayek's insights into the nature of legal evolution and the institutional requirements of the rule of law are invaluable to scholars grappling with the corruption of the law at the

hands of the state, and see legal competition as a solution (c.f., Randy Barnett, "Pursuing Justice in a Free Society-Part One and Part Two," *Criminal Justice Ethics*, Summer/Fall 1985 and Winter/Spring 1986).

In both areas of research, free banking and competitive legal system, Hayek has laid the foundation of a research program which young scholars are now pursuing. The sign of a great scholar is always the questions he leaves for others to answer or those he leads others to ask. Hayek will certainly leave us with just such a scholarly legacy.

## Conclusion

Hayek's contributions to economics and classical liberalism are vast, conducted at a level of scholarship that is perhaps without parallel. He derived his research program from Mises, but in his application of Misesian insights he stood on Mises' shoulders and went beyond him. It is true that modern Austrian economics begins with *Human Action*, but the usual dichotomy cast between Mises and Hayek is not only intellectually wrong, but dangerous to both the advancement and understanding of Austrian ideas and the defense of a liberal society. It is the Mises-Hayek tradition which we are attempting to advance. They are the complementary halves necessary to understanding the nature of the economic order and the systemic defense of economic liberty that follows from Austrian analysis.



In the next installment of this series we will look at Ludwig Lachmann, the Socratic gadfly of the Austrian system, who became interested in economics because of Mises' methodological writing, and subsequently studied at the London School of Economics with Hayek.

Peter Boettke is acting Assistant Professor of Economics at George Mason University, and Research Associate at the Center for the Study of Market Processes at George Mason University.