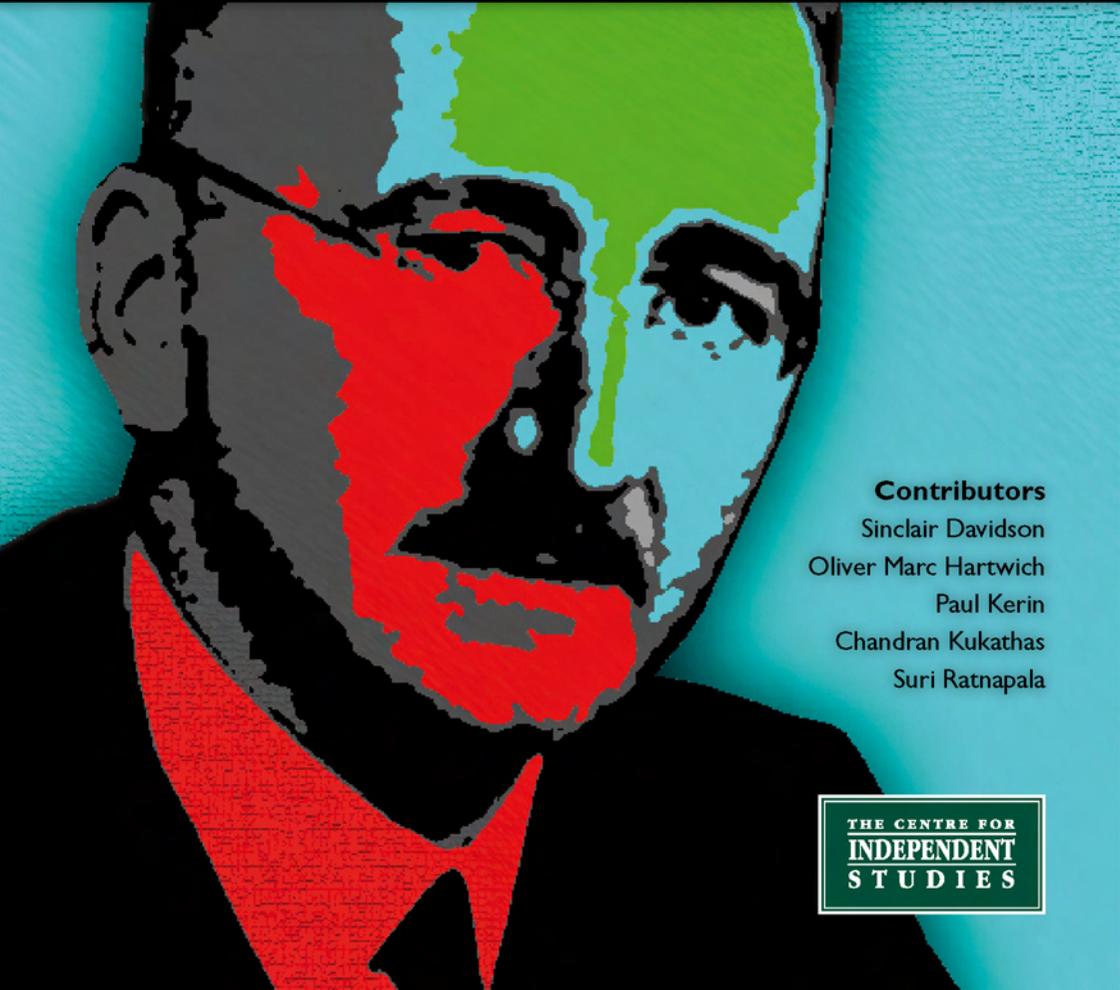


THE MULTI-LAYERED HAYEK

Edited by Oliver Marc Hartwich



Contributors

Sinclair Davidson
Oliver Marc Hartwich
Paul Kerin
Chandran Kukathas
Suri Ratnapala

THE CENTRE FOR
INDEPENDENT
STUDIES

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This collection of essays is based on the speeches presented at the event
'Hayek's Ideas in the 21st Century: An Exploration'
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Introduction

We have become used to abbreviating even the abridged. Lives, works and thoughts now often have to be condensed into short, snappy phrases if they are meant to become part of everyday discourse. There are now publishers condensing great works of world literature and science into five-page summaries. For a hefty fee, stressed executives can subscribe to a service that delivers the gist of books ranging from Adam Smith's *Wealth of Nations* to Milton Friedman's *Free to Choose*. The next step will probably be the Twitter version of Leo Tolstoy's *War and Peace* in 140 characters.

This drive to brevity is deplorable as it can reduce works of great complexity into catchphrases and caricature. Friedrich Hayek is the latest victim of the age of impatience.

Although there were not many thinkers of comparable depth and breadth in the twentieth century, the name of Friedrich Hayek has been used and abused as a synonym for a certain ideology. Former Australian Labor Prime Minister Kevin Rudd publicly denounced Hayek as the incarnation of 'extreme capitalism' to make him the counterpart in an unfavourable comparison with Soviet leader Leonid Brezhnev.

Such views of Hayek are widespread. If you asked people in the street—or rather in the cafés of fashionable suburbs—who this Friedrich August von Hayek was, the conventional answer would be that he was the most vocal proponent of unlimited capitalism, rivalled only by the late Milton Friedman.

As the contributions in this collection of essays show, this view not only reduces the complexity of Hayek's thinking but grossly distorts the real Hayek behind the caricature.

Instead of the one-dimensional Hayek of the caricature, we encounter a multi-faceted, multi-layered thinker. Hayek and his works are comparable to a prism or a mirror. A prism because it can break up questions into a colourful spectrum of their many

components. A mirror because one's view of Hayek depends on one's own political and philosophical convictions.

Hayek has been many things to many people. Former British Prime Minister Margaret Thatcher, a politician of the right, famously threw a copy of Hayek's *Constitution of Liberty* on the cabinet table and declared, 'This is what we believe in!' Social democrat and former German Chancellor Helmut Schmidt said, 'We're all Hayekians now,' effectively countering US President Richard Nixon's famous dictum, 'We're all Keynesians now.'

Others like Rudd saw Hayek as the embodiment of capitalism. To a small but vocal group of American libertarians, Hayek is a social democrat.

That Hayek is both admired and hated by people within different political camps may seem odd at first. How can the same person be regarded as a *laissez faire* extremist by some and an interventionist by others? How can some social democrats share their admiration for Hayek with conservatives? How can it be that some social democrats and right-wingers are both equally little fond of Hayek?

The reason is simple: Hayek was not only a thinker of great depth but also someone whose thinking developed or, should we say, matured over time. He was also one of the great interdisciplinary scholars who could tie loose ends from different fields of research together.

Such a complex mind must be puzzling to those trying to understand him. No wonder, then, that they were using shorthand methods to make this difficult Hayek more intelligible.

Hayek's work spanned decades, countries and multiple research areas. From the technical economist working in 1920s Austria to the theoretician of distributed knowledge at the London School of Economics in the 1930s, from the lone voice against the threat of totalitarianism still in London in the 1940s to the philosopher of liberty at Chicago in the 1950s and 1960s, to the social and legal philosopher for the rest of his life, Hayek has played many different roles throughout his life.

One of the ironies of Hayek's life must be the winning of the Nobel Prize, which he had to share with Gunnar Myrdal, an avowed

socialist. It was also ironic because by the time Hayek received it, he had left core economics subjects to deal with other issues. It is even more ironic because Hayek was given the prize for his contributions to the theory of business cycles from earlier in his career—economists today would probably consider Hayek's foundations of information economics as his most prize-worthy achievement. In Hayek's Nobel Prize, we can thus see how easy it is to get a partial and possibly distorted picture of Hayek.

What clearly differentiates Hayek from most present-day economists is his interdisciplinary foundation. Hayek's first doctorate was in law, not in economics. And had the opportunities for psychologists been better in 1920s Vienna, he may have well devoted more time to psychology—a subject in which he later published one major book, *The Sensory Order*.

Perhaps Hayek had himself in mind when he said, 'An economist who is only an economist cannot be a good economist.' In any case, he was right. Economics is a discipline with multiple connections to related subjects in law, history, sociology, psychology and political science. Against a technocratic view of economics as a mere tool of social optimisation, Hayek believed the economy could only be understood if considered within a social framework, which is also central to the utilisation of dispersed knowledge.

It is in this institutional way of thinking about economics that Hayek's interdisciplinary approach showed most clearly. However, in dealing with institutions, Hayek left the clinical views of textbook economics far behind. The world that Hayek sought to deal with was a messy place, not the sanitised ideal of two-dimensional diagrams, supply and demand graphs, and the like. In acknowledging the world in all its complexity, Hayek differed from those economists, even from some of his friends and teachers, who preferred a purely theoretical approach devoid of all empirical observations.

Hayek is also different from most of his academic colleagues in another aspect. He sought to convince others by his ideas. Why should this be surprising? Isn't it the most normal thing in the world for scholars to communicate the findings of their research? In theory,

yes but, in practice, many academics neglect to engage in the battle of ideas, confining themselves to a self-chosen ivory tower.

Not so Friedrich Hayek. To him, it was not enough to develop and find new ideas but also to communicate them widely. In particular, the idea of freedom in all its variations and applications was not only analysed and discussed again and again in his works but he also made it his personal task to spread the idea beyond the confines of academic literature. It was for this sake that Hayek established the Mont Pelerin Society as a group of like-minded intellectuals with the purpose of keeping the ideas of classical liberalism alive in the face of widespread statism. Another venture in the business of spreading the word of liberty was Hayek's help in establishing a network of independent research institutes and think tanks, of which the London-based Institute of Economic Affairs was the first. The Centre for Independent Studies plays a similar role in Australia.

Hayek had realised that most economists do not play a role in public life and leave the discussions of economic policy to journalists, intellectuals and politicians. This is still true today. If more academic economists engaged in public debates, there would be less of a role for institutes like the IEA or the CIS. However, Hayek clearly saw that there were not enough translators of economic principles into a language that the 'second hand dealers of ideas' (Hayek about the intellectuals) could understand.

From this outline of some of the milestones and achievements of Hayek's life, it should be clear that it is impossible to briefly sum up Hayekian thought. It is indeed quite likely that different people will understand Hayek differently—not because Hayek's message was unclear or ambiguous but because his work is rich in facets. It also depends on the period of Hayek's work you are dealing with. For someone whose intellectual life has spanned about seven decades, it is only to be expected that some of his ideas evolved over time.

So whatever else you may think about Hayek, one thing should be clear: Hayek's work does not render itself to any shortcuts, and attempts to break Hayek down into some easily digestible pieces are bound to fail. The best way of dealing with Hayek, therefore, is not

to give in to the widespread images and caricatures of him, whether they are sympathetic or hostile, but to engage with him directly by reading his ample writings.

The second best way is to read what eminent scholars of Hayek's works have written about him. It has been my pleasure to edit the current publication, which brings together five essays by four academics who all have their own and different approaches to Hayek's work. Chandran Kukathas introduces us to Hayek's philosophy of government. Paul Kerin discusses whether Hayek's views of cartels and monopolies are still relevant in today's business world and its regulatory environment. Sinclair Davidson has two essays in this collection: one on Hayek's monetary economics, the other deconstructing former Australian Prime Minister Kevin Rudd's critique of Hayek. Suri Ratnapala offers his analysis of Hayek's jurisprudence. These essays were delivered as speeches to the CIS at an event titled 'Hayek's Ideas in the 21st Century: An Exploration' in 2008 and updated for this publication.

This collection of essays has three purposes: to refute the caricature views of Hayek, to introduce readers to the 'real Hayek,' and, above all, to evoke a greater interest in dealing with Hayekian ideas.

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Sydney

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Understanding Hayek

Chandran Kukathas

Although some of this will be familiar to a number of you all, I will talk a bit about Friedrich A. Hayek since I am going first. I'll say a little bit about his life, how he came to the ideas that he became so famous for espousing, and then a little bit about his liberalism and the contribution he has made to liberal theory and to intellectual life.

Hayek was a European thinker from Austria whose career began as an economist. Although he won the Nobel Prize for economics in 1974, he had stopped doing economics for quite some time by that stage. He had turned his attention to politics much earlier when he decided to write *The Road to Serfdom*, which came out in 1944. He really never returned to economics, even though he wrote a number of economic pamphlets in that time.

As an economist, he wrote not as a new classical economist—someone interested in econometrics—but as someone who saw economics in the context of the history of ideas. Hayek wrote about economics because he was not only interested in technical questions such as the nature of trade cycles but also understanding how society functioned and explained through some sort of social theory. The economics that he developed flowed out of his broad interests in history, psychology, and what we now regard as sociology as well as the Austrian tradition of economics.

Hayek first came to prominence in the late 1920s and early 1930s as an economist because of some things that he wrote about trade cycles, which brought him to the attention of economist Lionel Robbins at the London School of Economics. He continued to receive attention in the 1930s because of the various disputes he had with John Maynard Keynes and, of course, for his contribution to what is now known as the Socialist Calculation Debate.

In the 1930s, socialism was in its intellectual heyday—it was a time when serious intellectuals believed that socialism and socialist central planning were real solutions to problems of economic organisation—that it was possible to redesign society along more rational lines to bring about a better world in which poverty was eliminated and economic production was on a more sound, more secure, and more rational footing. Hayek, along with his mentor Ludwig von Mises, in the 1930s did a great deal of work to show why socialism was technically impossible. Hayek showed that central planning, for all the good intentions of social planners and political leaders, was unlikely to lead to the kind of success that socialists anticipated.

It took some time, probably not until the 1970s and 1980s, before people realised that Hayek and von Mises' analyses were decisive and started to appreciate it. In fact, it was only in the 1990s that a number of socialists and economists started to say, 'we really need to go back and look at some of the things that Hayek and von Mises were saying.'

Early in his intellectual life, Hayek was not interested, other than in an indirect way, in questions of political philosophy. This changed in the 1930s when he was engaged in the Socialist Calculation Debate. Two developments were of critical importance. The first was obviously the rise of socialism, Stalinism in particular. Hayek, and almost everyone except for academics at universities, could see what was going on in the Soviet Union. He was horrified by the violations of human rights, but he could also see that this was a society on the verge of collapse. He was more worried, however, not about the collapse of economic life in the Soviet Union—that would take its own course—but that the ideas behind these enterprises would somehow become attractive and adopted in the West, eventually affecting its economic and political life.

Hayek became seriously aware of the effects of socialism, in part because he could see within Britain, where he was based, the ascendance of these ideas among fellow economists and intellectuals as evident from their writings. He became more concerned after the second important development in the 1930s—the rise of Hitler

and Nazism. He saw both these developments as a part of a similar movement, of the same stripe as socialism, and of people who wanted to try to control human life and society.

But in the case of the Nazis, it was even more dangerous because they had immediate imperial ambitions. And by the late 1930s, Hayek was convinced that the Nazis were going to make war. At this point, and right until the beginning of World War II, he decided that as a public intellectual he needed to take a stand and draw people's attention to this growing problem. This aspect of Hayek is little appreciated, but his correspondence in the 1930s, his papers, and his talks show how much he was concerned about the rise of Nazism. In fact, he started writing to the British government, and to the BBC, telling them to take notice of the seriousness of the growth of Nazism, and that the real problem lay in the fact that the Germans didn't understand what was happening to them and their country because the Nazis kept them in the dark.

In fact, in an interesting correspondence in the early years of the war, Hayek wrote to the BBC, saying he appreciated the job that they were trying to do but that their propaganda broadcasts were not up to scratch and they needed to try much harder. Significantly enough, he said that because the German people didn't know what was happening under the Nazis, it was the BBC's job to find out the truth. This meant finding out the truth, getting on board sympathetic German historians and intellectuals, and broadcasting the truth in Germany.

It is interesting to note that this was Hayek's conception of propaganda, and that propaganda didn't really become a dirty word until Goebbels used it. Until then, propaganda was no more than a technical term. Hayek's concern was making sure that the truth was told. This was what he did in the early years of the war, and it's on the basis of this experience that he decided to abandon economics and turn his attention to political process.

He had concluded by now that the triumph of Nazism and Stalinism, and even their defeat, and the resulting death of German intellectual and cultural life in the post-War period would endanger the civilisation of Europe itself.

So as an intellectual, he decided to do something about this. First, he embarked upon a new career as a political philosopher to revive and restate the philosophy of liberalism, which he thought of as the main intellectual alternative to socialism and totalitarianism. Second, he began the task of practical rebuilding of institutions through which intellectuals could interact with one another. He helped create the Mont Pelerin Society, which he hoped would bring together across Europe and the United States intellectuals of all stripes who were essentially opposed to totalitarianism.

Of course, he was criticised for this to some degree because some people at the end of the war were not interested in having anything to do with German scholars and considered them tainted. Others wanted a much purer intellectual movement—excluding those who were too far to the right and too catholic in interpreting liberalism or those who were too far to the left and too socialistic. Hayek's view was that it was necessary to build a broad church, because the main task was not to develop a pure doctrine but an intellectual alternative to totalitarianism, which meant a broad conception of liberalism.

And this is how we need to understand Hayek's liberalism, which he outlined beginning with *The Road to Serfdom* in 1944, *The Constitution of Liberty* in 1960, and his trilogy on law and legislation through the 1970s. He set out to build not only a little intellectual niche of ideas but a broad agenda of liberal thinking to which liberals of all kinds could contribute. So he was happy to accept people who were only vaguely sympathetic, even though some of them, Karl Popper, for example, were much more social democratic in outlook and really quite hostile to the free market in many respects.

But there was also a more libertarian or even anarchistic extreme of the liberal tradition. Thus, at the first session of the Mont Pelerin Society, both Popper and von Mises at different extremes stormed out of the meeting saying how they could not abide the socialists or anti-socialists, depending on where they stood.

Hayek's political attitudes were always moderate. He kept his eye on what he thought was the main game, which was the threat

posed by what he saw as a growing and, at that stage, undefeated menace—totalitarianism. This is what lay at the heart of Hayek's liberalism—a fairly broad church of political outlook with a history going back to the origins of the English Common Law and the development of early European systems of parliamentary government. It also went back to the more recent attempts to update liberal thinking and institutions, in the thought of the eighteenth century and in the ideas of the Founders of the United States.

Hayek saw liberalism as an evolving tradition but with a conceptual core, something he elaborated and developed in his political works. One idea that's central to this understanding of liberalism is his conception of liberal society as what he called an 'abstract order.'

It's quite a simple idea. Every society comprises people with different ends, desires and conceptions of what's valuable in life. Therefore, societies need rules to negotiate and interact with one another in a peaceful way and pursue their own distinctive ends. To ensure that these rules do not favour one particular person or group over another, they would have to have a certain kind of abstract quality, because when disagreements arise, people can appeal to the rule and the rule rules. The rule is not a tool by which to exercise power over others or win a preferred end at someone else's expense. The rule is something to which all defer.

But what happens when there are conflicts over how to interpret rules or their impact? Hayek responds by saying that an essentially liberal society appeals to ever more general rules that are ever more abstract. As society becomes more complicated, and as the system of rules becomes more elaborate, we get what he calls an abstract society.

The problem with the abstract society is that often the rules will generate outcomes that some people don't like, and the temptation is always to say, 'well, we should turn away from the rule because it's taking us in directions that we don't want to go.' To which the liberal replies, resist that temptation to do what we nowadays call 'targeting,' the temptation to say, 'that group is deserving, so let's target them for particular benefits because that's the right thing to do.'

Doing so would undermine the liberal order because it's essentially an abstract order. Hayek tried to elaborate this idea in political philosophy and by establishing the place of the state and government in a liberal political system.

Let me finish with this thought. Although he does say something about government and the state and their respective roles, what's striking about Hayek's thinking as elaborated in his theory of the abstract society is that these liberal institutions are not to be understood as subsuming society. Governments and states do not subsume society. They are simply elements or aspects of society.

What is society? Hayek says it's an order, an extended order of human cooperation. It does not have boundaries or limits. It simply has institutions that help regularise our interactions with one another. And in that respect, Hayek's conception of politics, of government, and of the political order, more generally, is striking because it's global and anti-nationalistic.

An Exploration of Hayek's Ideas in the 21st Century on Money and Inflation

Sinclair Davidson

Friedrich A. von Hayek is today highly regarded as one of the great philosophers of freedom. In comparison, his contributions to economic theory do not enjoy the same recognition, even among Hayek's political and academic friends.

James M. Buchanan is a good example of this perception. Buchanan, an economic Nobel laureate like Hayek, has written two appreciations of Friedrich A. Hayek. The first was a personal recollection written shortly after Hayek had passed away in 1992; the second was a more recent academic investigation of the 'Hayek difference.'¹ In the earlier piece, Buchanan argues that Hayek had wanted to return to his disciplinary roots and gave a series of lectures at the University of Virginia in 1961 called *A New Look at Economic Theory*. Hayek was dissatisfied, however, by his efforts and felt that he had no new insight beyond what he had developed in the 1930s and 1940s. In his later article, Buchanan argues that following the publication of *The Road to Serfdom* in 1944, Hayek could never return to being a technical economist. He had 'politicized himself, and for the wrong cause, an unforgivable sin in the intellectual atmosphere of midcentury.'² That academic 'sin' remains beyond the pale even today.

Buchanan asks what the Hayek difference might be—what is Hayek's net contribution to attitudes and ideas. According to Buchanan, Hayek's greatest contribution was as a philosopher in the tradition of classical liberalism. In that role, he published *The Road to Serfdom* and founded the Mont Pelerin Society. To be sure, his uniqueness rests on his contributions to economic thought, the notion of market process as *catallaxy*, and his understanding

of knowledge as being dispersed. Buchanan states that Hayek's early work as an economist has had no impact on the subsequent development of economic theory. That view is correct; although it is fair to say that the entire Austrian school has been neglected and practitioners in that school have done little to overcome that neglect. Buchanan sadly also ignores Hayek's literature on inflation written after World War II. Sadly because although this literature has had little or no impact on professional economists, I argue that the current monetary arrangements are closer to a Hayekian ideal than perceived.

Of course, many observers would argue to the contrary and dismiss Hayek's monetary views as 'crankish.' Indeed, anyone with just a passing knowledge of Hayek would mistakenly believe that he advocated a return to the gold standard. His views, however, were more nuanced than that and his understanding of inflation and inflationary pressures still contain important insights. In this paper, I hope to resuscitate something of Hayek's reputation as a monetary economist—at least in the eyes of those who are prepared to forgive him the sin of being a classical liberal.

Hayek's view of inflation

Hayek had lived and worked through the great post World War I inflation. The Austrian inflation had preceded the German inflation. He started working in October 1921 on a monthly salary of 5,000 (old) Kronen; in November, he had a salary of 15,000 Kronen; and by July 1922, he had a monthly salary of 1 million Kronen.³ Stefan Zweig describes the harrowing experience of the Austrian hyper-inflation:⁴

Soon nobody knew what any article was worth. Prices jumped arbitrarily ... In consequence of this mad disorder the situation became more paradoxical and unmoral from week to week. A man who had been saving for forty years and who, furthermore, had patriotically invested his all in war bonds, became a beggar. A man who had debts became free of them. A man who respected

the food rationing system starved; only one who disregarded it brazenly could eat his fill. A man schooled in bribery got ahead, if he speculated he profited. If a man sold at cost price, he was robbed, if he made careful calculation he yet cheated. Standards and values disappeared during this melting and evaporation of money ...

Hayek later wrote, 'I am indeed convinced that such a mismanagement of the currency is tolerated by the people only because, while the inflation proceeds, nobody has the time or energy to organise a popular rising.'⁵ In the first instance, we know that Hayek's understanding of inflation was personal—he later noted that the effects of inflation were bad and 'much more painful than most people understand who have not lived through one.'⁶

As an economist, Hayek defines inflation as 'an excessive increase in the quantity of money which will normally lead to an increase in prices.'⁷ This is a technical term for Zweig's 'melting and evaporation of money.' Some modern economists, including Milton Friedman, consider inflation as a 'steady and sustained increase rise in prices' and may have difficulty with this definition.⁸ Price increases, however, are a symptom of inflation. As Friedman makes clear, 'more rapid increase in the quantity of money than in the quantity of goods and services available for purchase will produce inflation, raising prices in terms of that money.'⁹ Ultimately, there is no difference between Hayek and Friedman on the cause of inflation, only a semantic difference in defining it.

Hayek argues that the 'constant misuse' of the term inflation to mean price changes leads to 'confusion' but is more restrained than his mentor Ludwig von Mises when making the point.¹⁰

What many people today call inflation or deflation is no longer the great increase or decrease in the supply of money, but its inexorable consequences, the general tendency towards a rise or a fall in commodity prices and wage rates. This innovation is by no means harmless.

To be clear, Hayek did propose that for practical purposes, the monetary authority could aim to stabilise 'some comprehensive price level.'¹¹ That does appear to be the standard anti-inflation technique. Hayek, however, indicated that the index should not only contain consumer prices but also be based on international prices and not just local prices.

Hayek is emphatic that there can be no such thing as 'cost-push' inflation. Inflation is a monetary phenomenon; 'neither higher wages nor higher prices of oil, or perhaps of imports generally, can drive up the aggregate price of all goods *unless the purchasers are given more money to buy them*' (emphasis original).¹² This is a particularly important point to stress in Australia: Trade unions do not cause inflation. Glenn Stevens recently argued, 'Inflation problems do not *have to start* with wages. Sometimes in Australia in the past they have started that way, but it should not be assumed that it will be that way on every occasion' (emphasis original).¹³ Although not intending to do so, Hayek provides a summary of Australian wage and inflation history.¹⁴

But unions can force a government committed to a Keynesian full employment policy to inflate in order to prevent the unemployment which their actions could otherwise cause; indeed, if it is believed that the government will prevent a rise of wages from leading to unemployment, there is no limit to the magnitude of wage demands—and indeed even little reason for the employers to resist them.

Historically, 'wage break-outs' were associated with inflation. But union demands *per se* did not cause inflation. Rather, government policy led to greater wage demands that, in turn, were accommodated by the monetary authority. As Hayek suggested, government relieved unions of responsibility for unemployment by promising to maintain full employment at any wage level. This policy is unlikely to continue now that the Reserve Bank is nominally independent of government.

Hayek took the view that all inflation could only be described as demand-pull inflation. He also, however, took the view that inflation was usually ‘engineered by governments and for the gain of governments.’¹⁵ Many economists have described the Australian inflation (prior to the global financial crisis) as being demand-pull inflation. According to the RBA governor, ‘For some time now, the Board has been seeking to slow the growth of aggregate demand, in order to reduce inflation.’¹⁶ Hayek does use the term aggregate or general demand, which some might take as his tacit support for current arguments about inflation in Australia. In reality, Hayek would not have provided any comfort to the RBA governor or his many apologists in the media.

In the first instance, it appears that Hayek is thinking of ‘money expenditure’ or ‘monetary demand’ when using the term ‘aggregate demand’ or ‘general demand.’ It includes the sum of household consumption expenditure, firm investment expenditure, government spending, and net exports. According to government, in 2007 and most of 2008 the Australian economy was at full employment *and* aggregate demand was greater than aggregate supply (i.e. the output produced in the economy). There is no suggestion that the Howard government used inflation to generate full employment—Australia was not experiencing a Keynesian inflation. The RBA wanted to decelerate the economy.¹⁷ Hayek did not support slowing the economy as a means of controlling inflation.¹⁸

I want emphatically to reject a misrepresentation of my argument which I have already experienced. I certainly do not recommend bringing about unemployment as a *means* in order to combat inflation ...

Hayek did believe that combating inflation would lead to unemployment, but did not advocate causing unemployment as an anti-inflation tool. The increase in unemployment would be due to the unwinding of the distortionary effects of inflation. The causation is very different to the RBA solution. During times of inflation, some sectors of the economy attract short-term benefits and greater

resources. Once the inflation ceases (or is not accelerating) those resources become unemployed. A successful anti-inflation program will increase unemployment. So too will a slowing of the economy. It is important to distinguish between the RBA combating inflation and merely slowing the economy.

Hayek would have approved of government decisions to cut spending. He took the view that monetary and fiscal policy should be pursued independently of each other, and this could only be done 'so long as government expenditure constitutes a comparatively small part of all payments.'¹⁹ He also thought government debt should be at low levels. Once government constituted too large a share of national income, inflation was likely to follow. So Hayek would approve of cutting government spending, but it is not clear whether he would approve of hoarding surpluses to subsidise future government spending. According to Hayek, tax cuts would not lead to inflation because inflation is the result of individuals having too much purchasing power, not having earned too much, or having worked too hard.

In order to better understand this point, we need to look at Hayek's solution to inflation.²⁰

The first necessity is to stop the increase of the quantity of money, or at least to reduce it to the rate of real growth of production—and this cannot happen soon enough.

Inflation is the creation of too much money. It is caused when the monetary authorities issue too much money into the economy. Hayek uses words such as 'cheat' and 'deceit' when describing inflation.²¹ Tax cuts do not create excess money in the economy or involve cheating or deceit; instead, they allow individuals to keep the money they have earned through the division of labour and trade. So in Hayek's model, tax cuts do not cause inflation but rather the government or the monetary authority. In Australia, which has a nominally independent monetary authority, inflation is caused by expanding the supply of money beyond the rate of real growth in the economy.²²

In an article on Zimbabwe's inflation, Alan Mitchell provides one of the best explanations of demand-pull inflation.²³

Zimbabwe's hyperinflation is a textbook case of too much money chasing too few goods. With the decline of the economy and tax revenue, the Mugabe government increasingly resorted to printing money to finance its activities. As inflation took off, economic activity was further damaged and the government's reliance on the printing press increased; so the vicious circle continued.

Demand-pull inflation occurs when government injects too much money into the economy, not when economic growth is too high. The solution to Zimbabwean inflation is not to slow the economy.

Finally, Hayek did not only blame government and monetary authorities for inflation.²⁴

... the majority of economists whose advice governments have been following in Britain and the rest of the Western world during this period have thoroughly discredited themselves and ought to do penance in sackcloth and ashes. What was almost unquestioned orthodoxy for close on 30 years has been thoroughly discredited.

This is surprisingly harsh language for Hayek who was known to be 'old-world' polite and spoke well of even John Maynard Keynes.²⁵ Later, he described some economists as 'dissenters and cranks', especially 'those Continental economists who by their advice on policy became responsible for the great inflations of the 1920s.'²⁶ In one sense, Hayek was bitter and blamed himself for not opposing Keynes' *General Theory* earlier.²⁷ It is not clear, however, that he would have succeeded in convincing either the profession or political elites at the time that Keynesian economics was wrong. After all, here we are 30 years after Hayek wrote those harsh words, and Keynesian economics is still being taught in universities and practised at the highest level of government.

Hayek and the monetary system

Hayek believed that government was responsible for inflation and that it had become easy to inflate after the 'destruction of the gold standard.' One of the difficulties Hayek faces as a theorist is the perception that he favoured returning to the gold standard. He sympathised with people who regarded a return to the gold standard as the 'real solution' to inflation. He went as far as to say, 'I still believe that, *so long as the management of money is in the hands of government*, the gold standard with all its imperfections is the only tolerable safe system' (emphasis original).²⁸ For this opinion, he is sometimes dismissed as a crank. Of course, doing so now would show ignorance of his writings for the Institute of Economic Affairs (IEA) in the 1970s.

Mark Skousen writes that as early as 1937, Hayek viewed the gold standard as politically desirable but not economically desirable.²⁹ Hayek gave two reasons for why a return to the gold standard would not be practical: first, the gold standard was an international standard, and international coordination would be required to reintroduce it; second, the gold standard relied on the 'mystique of gold' and 'the general belief that to be driven off the gold standard was a major calamity and a national disgrace.'³⁰ This attitude and belief had ceased to exist.

Hayek proposed a reserve commodity currency where money would be issued on the basis of a portfolio of commodities, but by the 1970s called for the denationalisation of money or choice in currency³¹—the idea that individuals should be able to transact in any currency or commodity they choose.³² This idea is not as radical today as it was in the mid-1970s when the world economy was characterised by exchange controls and severely repressed financial markets.

There could be no more effective check against the abuse of money by the government than if people were free to refuse any money they distrusted and to prefer money in which they had confidence.

By exposing national currency to competition, governments would have to behave responsibly and maintain the value of their currency. Under such an arrangement, ‘those countries trusted to pursue a responsible monetary policy would tend to displace gradually those of a less reliable character.’³³ Two of Hayek’s proposals that didn’t catch on were that banks and other monetary institutions be allowed to issue their own currencies (and trade alongside all other currencies) and abandoning the notion of legal tender. He also suggested that the notion of legal tender be abandoned, except that if the government were to issue its own currency, it should specify what currency be accepted for tax purposes, settlement of debt, and payment of torts. With minor exceptions, financial institutions do not issue their own currencies and the notion of ‘legal tender’ is still with us.

It is quite remarkable that the IEA critiqued the currency proposal. Harold Rose wrote that Hayek’s proposal was less revolutionary than it sounded and he had little faith in its efficacy—he doubted that governments would abolish exchange control.³⁴ Douglas Jay wrote:³⁵

But in thinking you can take control of the currency out of the hands of modern elected governments, and put it in the hands of some mysterious wise men meditating in some ivory tower, Professor Hayek is flying in the face of reality. The public simply will not allow control of money to be put beyond their control any more than control of laws or taxes. The only hope, even if a frail one, is to educate governments to act sensibly.

As it turns out, Rose was quite correct; Hayek’s proposal was not as radical as it seemed.

The current domestic and international financial monetary system does not immediately resemble what Hayek called for in his proposal—that would represent a triumph of human design over human action. Still, today’s monetary system does have remarkable similarities to Hayek’s proposals. Margaret Thatcher wrote in her autobiography that Nigel Lawson devised a scheme

based on Hayek's proposals for the euro, but that proposal did not get much traction with the 'statist' Europeans.³⁶ Governments continue to issue their own currency, but most financial institutions issue their own credit cards. Individuals can, in many economies, hold a credit card from any bank in the world. Individuals can own bank accounts anywhere in the world—often denominated in (almost) any currency. Currencies do compete against each other in international markets and, in many economies, the US dollar has displaced the local currency as the currency of choice. Exchange controls have been lifted in many parts of the world, and the control of money is largely beyond public control. Individuals can choose to contract in any currency, yet most advanced economies are happy to use the local currency. As Hayek indicated, 'unless the national government all too badly mismanaged the currency it issued, it would probably continue to be used in everyday retail transactions.'³⁷

In short, it is not correct to classify Hayek as a 'gold-bug,' and the world's financial system largely reflects Hayek's agenda. The world has largely arrived at this point not through conscious planning or even following Hayek's advice but through trial and error—a process Hayek would have approved of. Of course, the world does not operate a free banking system, and central banks are not about to be closed down. On the other hand, individuals in advanced economies are usually free to organise their finances and bank accounts as they see fit. The greatest danger to this monetary structure is not financial repression *per se* but rather the so-called 'war on terror' and the anti-liberal money laundering laws and tax harmonisation policies that are becoming commonplace.

Conclusion

Hayek had a deep and personal understanding of inflation, which he considered the greatest threat facing modern economies. Inflation is seductive—Hayek compared inflation to drug taking—and is known to have destroyed economies. Hayek's contribution goes beyond his classical liberal philosophy; he was known before the Keynesian revolution as a serious—even technical—economist. For a whole range of (bad) reasons, his influence as an economist

has waned over the past 70 years. This is unfortunate because, as I have tried to show here, he still has much to teach us about inflation. For example, I have not touched on his argument that indexation is not a solution to inflation and may accelerate inflation. His ideas in monetary economics are under-developed, with few economists studying them rigorously.

It is easy to argue that Hayek provides us with few policy differences from current policy settings. Yet, his understanding of inflation allows us to see that tax cuts would not fuel inflation. We also see that arguing private demand causes inflation is nonsense. Insufficient investment in infrastructure also does not cause inflation.

Endnotes

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James M. Buchanan, *Why I, Too, Am Not a Conservative: The Normative Vision of Classical Liberalism* (Massachusetts: Edward Elgar, 2005).
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- ³ Friedrich A. Hayek, *Hayek on Hayek: An Autobiographical Dialogue*, Stephen Kresge and Leif Wenar (eds.), (Chicago: The University of Chicago Press, 1994), 70.
- ⁴ Stefan Zweig, *The World of Yesterday* (Lincoln: University of Nebraska Press, 1943), 291–292.
- ⁵ Friedrich A. Hayek (1975), 'Inflation, the Misdirection of Labour, and Unemployment,' in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge, 1978), 203.
- ⁶ Friedrich A. Hayek (1975), 'Further Considerations on the Same Topic,' in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge, 1978), 217.

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- 8 Milton Friedman, *Dollars and Deficits: Inflation, Monetary Policy and the Balance of Payments* (Prentice-Hall, 1968), 21.
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- 15 Friedrich A. Hayek, 'Denationalisation of Money,' as above, 30.
- 16 Glenn Stevens, Opening Statement to House of Representatives Standing Committee on Economics (Sydney, 4 April 2008).
- 17 See Steven Kates, 'There's inflation, then there's nirvana,' *The Australian Financial Review* (25 October 2007), 79.
- 18 Friedrich A. Hayek, 'Inflation, the Misdirection of Labour, and Unemployment,' as above, 205.
- 19 Friedrich A. Hayek, *The Constitution of Liberty*, as above, 327.
- 20 Friedrich A. Hayek, 'Inflation, the Misdirection of Labour, and Unemployment,' as above, 206.
- 21 For 'cheat' see Friedrich A. Hayek (1959), 'Unions, Inflation and Profits,' in *Studies in Philosophy, Politics, and Economics* (Chicago: The University of Chicago Press, 1967), 282. For 'deceit,' see Friedrich A. Hayek, 'A Tiger by the Tail: the Keynesian Legacy of Inflation,' *Hobart Paperback* 4 (second edition) (London: The Institute of Economic Affairs, 1978), 93.
- 22 See Alex Robson, *Are Tax Cuts Inflationary?* (Australian National University, unpublished, 2007). Robson calculates a correlation of 0.975 between smoothed changes in CPI and excess growth in the stock of currency for Australia over the period 1970–2007. This is unambiguous evidence that inflation is a monetary phenomenon.
- 23 Alan Mitchell, 'First, slow the printing press,' *The Australian Financial Review* (7 April 2008), 25.
- 24 Friedrich A. Hayek, 'Further Considerations,' as above, 209.

- ²⁵ George Selgin has shown how both Keynes' and Hayek's views on inflation converged over time. See 'Hayek versus Keynes on how the price level ought to behave,' *History of Political Economy* (Winter 1999), 699–721.
- ²⁶ Friedrich A. Hayek, 'Denationalisation of money,' as above, 75.
- ²⁷ Friedrich A. Hayek, 'A Tiger by the Tail,' as above, 99–106.
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- ²⁹ Mark Skousen, *Economics of a Pure Gold Standard* (third edition) (The Foundation for Economic Education, Irvington-on-Hudson, 1996), 2.
- ³⁰ Friedrich A. Hayek, *The Constitution of Liberty*, as above, 335.
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- ³⁴ Harold Rose, *Commentaries on 'Choice in Currency: A Way to Stop Inflation'* (London, The Institute of Economic Affairs, 1976), 26.
- ³⁵ Douglas Jay, *Commentaries on 'Choice in Currency: A Way to Stop Inflation'* (The Institute of Economic Affairs, London), 28.
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Hayek, Monopolies and Cartels in the 21st Century

Paul Kerin

Friedrich A. Hayek expressed strong views on government-owned monopolies, government-protected private monopolies, ‘natural’ private monopolies, and cartels—as he did on any subject he tackled! However, much has changed in the last half-century. Fewer government-owned monopolies exist. Some were abolished altogether, some privatised with government-protected monopoly franchises, and some privatised and exposed to competition. Many government-protected private monopolies lost their protected status, but we tend to underestimate the number that remain. Privatisation has changed the nature of vested interests and incentives to sustain government protection. Structural factors, including technological change, have influenced the prevalence and size of non-government barriers to competition—and therefore the feasibility of creating/sustaining monopolies and cartels—in many industries. Progress in the fields of industrial organisation, game theory, and business strategy have changed our understanding of the extent to which non-government barriers to competition can emerge in many industries. Observed behaviours of politicians, regulators and vested interests have made many realise how perceptive Hayek really was. What does all this change mean? Are Hayek’s prescriptions still valid—or even more valid—today? If valid, is applying them relatively more—or less—valuable today than in the past?

Introduction

I must begin by declaring my own vested interests:

1. Hayek is one of my all-time heroes—although largely for reasons that have little to do with the topic of today’s talk.

2. While I disagree with Hayek on some issues—including what (if anything) society ‘should’ do about monopolies and cartels—I have felt the need to defend him against many ill-informed critics, including Prime Minister Kevin Rudd.¹
3. I have lobbied the odd vehement criticism against monopolies, monopsonies and cartels, and attempts to gain/sustain monopolies/monopsonies/cartels in many and varied industries: AFL Football,² aviation,³ box manufacturing,⁴ export wheat marketing,⁵ grain handling,⁶ labour supply,⁷ mail service,⁸ pharmacy,⁹ potato marketing,¹⁰ securities markets,¹¹ taxis,¹² telecommunications,¹³ television broadcasting,¹⁴ tow trucks,¹⁵ public transport,¹⁶ water supply,¹⁷ and workers’ compensation.¹⁸ The only article I ever wrote that was not published—a rant against newsagents’ local monopolies¹⁹—is but one example of the subtle powers that monopolies can exert to retain entrenched positions.
4. I have also lobbied the odd vehement criticism against government actions—and non-actions—to aid and abet monopolies/monopsonies/cartels.²⁰
5. I have advocated much stronger government-imposed penalties, including jail terms, against price-fixing.²¹
6. My own business experiences—particularly as chairman of a food market with 70 to 80 retail tenants—have impressed on me a strong view that we economists tend to greatly underestimate the extent to which price-fixing really does exist, the damage it does, and the multitude of ways in which it can be sustained.²²

These revealed preferences of mine suggest that my views on monopolies/ monopsonies/cartels and what (if anything) governments should do about them are *somewhat* aligned—but largely at odds—with Hayek’s last stated views on these issues. As I find being at odds with Hayek to be a rather disconcerting position, I attempt to justify myself in the remainder of this paper.

What did Hayek *Really* Think About Monopolies and Cartels?²³

Hayek's views on almost everything are misrepresented frequently. His views on monopolies/cartels are no exception.

In a 2006 speech to this very Centre, Rudd²⁴ attacked Hayek as the guru of unconstrained 'free market fundamentalists.' While Hayek certainly favoured *competitive* free markets as the ideal means of organisation (at least in the absence of standard drivers of market failure)—and he was much more free-market than Rudd—he actually advocated more government intervention²⁵ than is generally recognised (and more than his fellow Austrian school economists would have wished).

Hayek's views on monopolies/cartels are particularly prone to misrepresentation for several reasons:

1. He actually wrote relatively little specifically on these subjects (particularly in comparison to his voluminous writings on other topics).
2. Partly because of this, his views are often assumed to be the same as those of his Austrian school colleagues—particularly his famous mentor Ludwig von Mises; von Mises and most Austrian school members (both pre- and post-Hayek) did not see monopolies/cartels as serious problems or advocate that governments do anything about them.
3. Hayek's own views on these subjects changed markedly over time. That they did should be seen as praiseworthy. It reflects his emphasis on imperfect knowledge and willingness to adapt as knowledge grows—and reinforces his objective, fact-based approach to economics.²⁶

Ellen Frankel Paul has provided perhaps the best exposition of Hayek's views on monopolies/cartels. In this section, I draw liberally on her exposition.²⁷

Frankel Paul noted that of all Hayek's writings about the role of government, those concerning monopolies were 'perhaps the most tangled.' As well as changing over time, they were sometimes

vaguely stated and self-contradictory at points in time. While Hayek mentioned monopolies/cartels and antitrust law in passing in several works, most of his writings on these subjects were contained in *The Constitution of Liberty* (1960) and *Law, Legislation and Liberty, Volume 3: The Political Order of a Free People* (1979)—which Frankel Paul labeled ‘Hayek I’ and ‘Hayek II,’ respectively. However, his statements in *Individualism and Economic Order* (1948) represent an important starting point—so I’ll call them ‘Hayek 0.’ These three snapshots in time reflect Hayek’s views at the ages of 49, 61 and 80, respectively.

Hayek 0

Hayek (1948) most closely reflected the views of von Mises (1927).²⁸ Hayek 0 displayed great scepticism about any role for government in controlling monopolies and (correctly) blamed governments for creating/sustaining ‘artificial’ monopolies in various ways, such as granting exclusive licences and patents—and even through antitrust laws. He vilified government attempts to legislate against cartels, monopolies and restraints of trade because, rather than enhancing competition, they actually ‘greatly assisted the growth of monopoly.’

Hayek I

Twelve years later, Hayek’s views were not much different, although Hayek (1960) did argue that it may be an appropriate government role to restrict contracts in restraint of trade.²⁹

Hayek, like von Mises, argued that monopoly *per se* was not a problem unless substantial ‘artificial’ barriers to entry existed. This really anticipated the ‘contestability theory’ propounded by Baumol 22 years later.³⁰

Hayek distinguished between different types of monopolies and entry barriers. He saw no problem at all with ‘enterprise monopolies’—those created through enterprise, such as superior skills, experience, innovations, and other assets. Those assets are entry barriers but not ‘artificial’ ones—they generate customer benefits

and/or reduced costs. He therefore saw no role for government in circumventing such monopolies.

Like von Mises, Hayek also believed that these monopolies are generally temporary, eventually crumbling when their superiority fades—for example, because an external shock like a technological change makes the former superiority obsolete and/or a new player innovates with a business model that embodies some new source of superiority.

Hayek saw a problem only with ‘artificial’ barriers, which he attributed almost entirely to governments. He particularly objected to governments granting privileges and exclusions to labour unions because they both restrained trade and facilitated coercion. His principal recommendation was therefore that governments create no more ‘artificial’ barriers—and eliminate all existing ones.

Excluding monopolies/cartels supported by government artificial barriers, Hayek believed the prevalence of monopoly/cartel excesses was quite limited. His only concern was what he believed to be ‘rare’ cases in which ‘coercion’ was possible—when monopolists/cartels controlled ‘an essential commodity on which people were completely dependent.’ While he believed them to be rare, he did express real concern about them.

However, even here, his proposed role for government was very limited: simply a *per se* rule requiring monopolists to not discriminate between customers. This may seem strange to neo-classical economists, who long-ago demonstrated that perfectly discriminating monopolists would generate no (static) welfare losses compared to perfect competition. But Hayek’s recommendation reflected his emphasis on dynamics—his point being that monopolists may discriminate to prolong their monopolies.³¹

Beyond this simple *per se* rule, Hayek was reluctant to entrust governments with any *discretionary* enforcement power. He was ‘increasingly skeptical’ of resulting benefits because of the arbitrary nature of enforcement—he claimed that governments’ enforcement records were ‘so deplorable that it is astounding that anyone should still expect that giving governments discretionary powers will do anything but increase’ entry barriers.³² He expected discretionary

government enforcement powers to do more harm than good—they would play favourites, hurt ‘good’ enterprise monopolies, and permanently entrench ‘bad’ monopolies that, in the absence of interference, would be merely temporary.

Hayek’s rationale was, at least implicitly, based on two causes of ‘government failure’ that we are all well aware of today: imperfect information and incentive (agency) problems.

Hayek II

The chapter ‘Government Policy and the Market’ in Hayek (1979), written only 19 years after Hayek I, represents his most developed and extensive writing on monopolies/cartels. In it, he argued for more government action against monopolies/cartels. This reflected his increasing concerns about two harmful effects of monopolies/cartels and a somewhat greater optimism about the benefits of government action. For the first time, he advocated antitrust law—a rule-setting role for government—although he remained reluctant to recommend an enforcement role for government.

Nevertheless, Hayek reached this new stance with reluctance—Frankel Paul describing his new perspective as reflecting ‘an exercise in ambivalence.’³³

Hayek went to considerable trouble to explain this ambivalence.

He had always mistrusted antitrust law because he saw it as embodying the neoclassical model of perfect competition as the ideal market system. Hayek’s many key insights by this time on the discovery and use of knowledge strengthened his case. While perfect competition assumes perfect knowledge, Hayek (like other Austrians) saw competition as a dynamic ‘discovery process’—a mechanism that allows players to discover and utilise their separate knowledge, skills and opportunities to achieve results that cannot be predicted at the outset.

Hayek emphasised the role that self-interest plays in prompting individuals to use their knowledge to find the most profitable business models (e.g. economical production methods). Innovation is stimulated because whoever finds new methods first may earn temporary profits—but they soon disappear when the player does

not maintain an innovation lead. Hayek warned that reaping rewards from innovation should not be illegal.

Hayek II expanded on his concerns about the downsides of monopoly. To the downside noted in Hayek I—discrimination in regard to essential products—he added a second: concern that monopolists may prevent entry of competitors. He recognised that while monopolies may have *achieved* their monopolies through past superiority, they may use their incumbency to ‘protect and preserve their monopolistic position after the original cause of their superiority has disappeared.’³⁴ Hayek saw a role for government in preventing both of these monopoly downsides.

While he believed that ‘it would not be desirable to make all discrimination illegal,’³⁵ he argued that monopolists discriminating to restrict competition ‘clearly ought to be curbed by appropriate rules of conduct.’³⁶

Hayek argued that antitrust could play a legitimate role in moderating monopolists/cartels using their market power to present others with ‘artificial’ barriers to prevent others from ‘serving the customer better.’³⁷ This is a different type of ‘artificial’ barrier to those imposed by governments. Hayek acknowledged that when a monopolist can use its power to influence the market behaviour of others to protect itself against competition, ‘there is indeed a strong argument for preventing him from doing so.’³⁸

However, he continued to draw careful distinctions between different types of monopolies/cartels. He reinforced that ‘enterprise monopolies’ were ‘wholly different’ and caused no problem, provided their positions simply reflected ‘serving their customers better than anyone else, and not by preventing those who think they could do still better from trying to.’³⁹

However, because he doubted that governments had sufficient knowledge to prosecute successfully, he suggested not making such behaviour a punishable offense but rather leaving it to competitors to sue for damages. Hayek saw the government’s role simply as setting the rules to enable potential competitors to take action against monopolists. He still left enforcement out of the government’s hands.

While he acknowledged this second downside and therefore saw a role for antitrust, he continued to see government-abetted monopolies as the more ‘serious problem.’⁴⁰

Hayek II also further strengthened his earlier views on restraint of trade, recommending that all agreements in restraint of trade be declared invalid and legally unenforceable, without exception. Here, his concern was with cartels. He preferred a *per se* rule rather than prohibition with penalties involving government discretion. Again, this would rely on the private sector for enforcement—customers or potential competitors could sue a monopolist/cartel tried to coerce them by threatening to rescind ‘usual services’ unless they conformed to the monopolists’ demands.

Hayek’s preferred solutions to both downsides were therefore government setting *per se* rules and then relying on private initiative to sue and the courts to arbitrate. Again, this reflected his pessimistic view on the likely failures of discretionary government enforcement, which he believed would result in ill-informed, arbitrary actions, which would inevitably favour some ‘bad’ monopolies and disfavour some ‘good’ ones.

I agree with several of Hayek’s key views and prescriptions, in particular that:

- Most monopolies/cartels are due to government-created/sustained entry barriers. Indeed, of the 18 monopolies/cartels⁴¹ that I’ve attacked, all but five exist(ed) because of contemporary explicit government entry restrictions. Even of those five, two (labour supply, telecoms) were the legacy of past government entry restrictions or other government aiding/abetting of monopolists; and in two others (AFL, newsagents), governments have either provided exemptions from competition laws or turned a blind eye.
- Governments should eliminate all government-created/sustained entry barriers. Hayek would particularly despise such still-remaining barriers over ‘essential’ products such as water.
- Governments should favour *per se* rules rather than ill-defined, vague provisions that leave much discretion in the hands of regulators, politicians and courts.

- The many reasons to be concerned about ‘government failure’—information gaps and misaligned incentives being high on the list.

However, I disagree with Hayek on several issues; taken together, these are sufficient to push my views on the trade-offs in favor of stronger government action. My main disagreements concern the prevalence, persistence and damage of monopolies/cartels, and the relative effectiveness of private versus public enforcement, as explained below.

Prevalence

Hayek (like von Mises) underestimated the prevalence of non-enterprise non-government entry barriers. Ludwig von Mises (1949) acknowledged that such barriers could exist but claimed (with no evidence) that ‘their economic significance would be rather small.’⁴² Mises was a brilliant theorist but notoriously anti-empiricism.

This is somewhat surprising, given Adam Smith’s (1776) famous assertion that ‘people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public.’⁴³ Smith also thought that the government was impotent to prevent this: ‘it is impossible, indeed, to prevent such meetings by any law which either could be executed, or would be consistent with liberty and justice.’⁴⁴ The reason von Mises thought its prevalence ‘small’ was because non-government, non-enterprise entry barriers were low and transient.

Monopolies/cartels are much more prevalent than von Mises or Hayek thought. Monopoly—to some degree—is the norm, not the exception. Developments in economics in recent decades explain why this is so: imperfect information, search costs, switching costs, transactions costs. While monopoly is everywhere, the prevalence of monopoly that is worth doing something about is small—but still higher than Hayek believed.

Persistence

Prevalence at a point in time wouldn't matter very much if monopolies/cartels were short-lived. But evidence suggests otherwise. For example, in their extensive survey of hundreds of cartels over more than a century, Connor and Bolotova found a 'mean duration' of 8.6 years, with a maximum of 98 years.⁴⁵ But that's only measuring the time between the claimed start (which defendants naturally understate) and discovery. Most cartels are not discovered, so the true mean duration would be beyond 8.6 years. In short, cartels can persist for long periods of time.

This evidence is consistent with my own—admittedly anecdotal—experiences, such as my food market. One reason why cartels persist longer than von Mises and Hayek expected is because they overlooked more subtle means of enforcement such as intimidation. While such actions may be illegal, imperfect information and monitoring/enforcement costs help sustain such behaviours.

The Austrians made good fists of dismissing their importance of many of the 'old' entry barriers. But more recent advances in the strategy literature—such as the importance of learning effects,⁴⁶ scope economies, network effects, virtuous circles, and the difference in outcomes of multi-period games versus single period games⁴⁷—help explain why entry barriers are often greater—and more persistent—than the Austrians expected.

True, few cartels are likely to last as long as the De Beers diamond cartel—and even that has largely disappeared over the last two decades. But cartels like OPEC that are difficult to sustain for long periods or go through cycles can cause enormous damage over short periods.

Mises is right that in the long-run, non-government non-enterprise monopolies/cartels cannot persist. But as Keynes said, 'in the long run, we're all dead.'

Damage

Hayek had little/no evidence available with which to assess the extent of the damage generated by monopolies/cartels. It is easy to underestimate.

The best research on this subject is by Purdue University's John Connor, who surveyed 1,040 cartels over 235 years. He estimated the median price overcharge to be 25.0% (18.8% for US domestic cartels and 31.0% for international cartels); 62% of cartels overcharge by at least 20%. As Connor notes, these findings 'sharply contradict' the views of those who think cartels do not do sufficient damage to warrant control.⁴⁸

But economists tend to overlook costs of cartels/monopolies other than those generated by higher price margins. As Australia experiences with various monopolies, such as AWB and ASX, have highlighted, insulation from market pressures raise direct cash, can generate substantial other costs (reputation damage due to dysfunctional behaviour), reduce quality, and cause substantial resources to be wasted protecting turf.

Even if monopolists/cartels reaped no price margin gains, I would still advocate government action.

Effectiveness of private enforcement

Hayek places great faith in the pressures that potential lawsuits from potential competitors and customers would place on monopolists/cartels. But this has not panned out as Hayek expected for several reasons:

1. Customers generally do not take the lead in suits—except in the rare case when there are very few of them. In most cases, individual customers have little incentive to sue (as the cost per customer is small relative to the monopolist/cartel's gain—even though the total costs over all customers are substantial and greater than the monopolist/cartel's gain). And it is difficult to organise large numbers of customers into class actions.
2. Potential competitors recognise that incumbents can draw out suits for years and impose substantial costs on them. This is a great investment for incumbents, as the present value of delaying competition is enormous and the deterrent effect on potential challengers is strong. Potential competitors also face major uncertainties (costs, customer switching readiness, incumbent

reactions, etc), of which incumbents possess much better knowledge.

Effectiveness of government enforcement

We all know governments fail—and I have been a vehement critic of government failure.

Nevertheless, I believe that the benefits of strengthening monopolist/cartel incentives to behave themselves outweigh the costs.

In the past, very little empirical evidence existed on the effectiveness of government enforcement. Mises didn't care about empirics anyway. Hayek did consider anecdotal evidence. But strong empirical evidence has become available only relatively recently.

Only six years ago, Bittlingmayer wrote:⁴⁹

The empirical case for antitrust remains weak. We know that polio vaccine effectively eradicated polio; we do not know that the antitrust laws have made us better off. Twenty years ago, George Stigler wrote: 'There have been no persuasive studies of the effects of the Sherman and Clayton Acts throughout this century.' Little has changed.

Kee and Hoekman investigated the impact of competition law on industry mark-ups over time and across many countries. They found that actual and/or potential competition are major sources of market discipline in concentrated markets, but that competition law does have a significant additional impact on mark-ups through its positive effect on the number of competitors.⁵⁰ However, it is not clear why the mere presence of antitrust laws encourages entry. This may be not just because of direct enforcement activities but because the competition regulator's advocacy activities constrain the erection/maintenance of artificial government entry barriers.

More recently, Connor and Bolotova found a 'secular decline' in cartel overcharges 'as antitrust-enforcement regimes have stiffened' and concluded that 'with time antitrust regulation seems to have

become more effective.⁵¹ Connor (2007) found cartel mark-ups have fallen over time, although they are still substantial. In the post-1990 era, when penalties (fines, jail terms, etc) have been greater by far, overcharges of discovered cartels were significantly lower, suggesting that ‘the worldwide trend towards intensification of cartel penalties has been desirable.’⁵²

So what should the government do?

Most importantly, the government should do the things that Hayek and I agree upon—in particular, refrain from creating/sustaining entry barriers and remove the many currently in existence due to previous government actions.

In the short-term, the Australian government should pass legislation—that the Howard government sat on for years—to introduce jail terms for price-fixing.⁵³ Consistent with Hayek’s view on the value of *per se* rules over discretion, the draft legislation should not be watered down in ways that are being proposed—such as adding a rider that an offender must have ‘acted with dishonesty’ in order to suffer criminal penalties.⁵⁴ This just makes enforcement difficult and therefore reduces the deterrent effect.

Of course, some current/recent ‘enforcement’ activities conducted purely for political show—like the ACCC’s expensive regular price check surveys across many petrol stations—are silly. They are not justified on cost/benefit grounds and should be ditched.

Would Hayek agree with me?

My major difference with Hayek is that I see a need for a strong government *enforcement* role. Hayek’s views changed markedly in the 19 years between his major writings on the subject. It is very likely that his views would have changed substantially in the 29 years since he last wrote on monopoly. I held similar views to Hayek on monopolies/cartels when I began studying economics about the time of Hayek’s last writings on the subject. Much has changed in the world since then. We now know more about barriers to entry, monopoly, cartels, and the impact of antitrust.

True, some Hayek's soul mates changed their views in the opposite direction to what I propose. For example, another of my all-time heroes, Milton Friedman, confessed in 1998:⁵⁵

My own views about the antitrust laws have developed greatly over time. When I started in this business, as a believer in competition, I was a great supporter of antitrust laws, I thought it was one of the few desirable things that the government could do. But as you watch what actually happened, you saw that instead of antitrust laws promoting competition, it tended to do exactly the opposite. Because they tended, like so many government activities, to be taken over by the people they were supposed to regulate and control. And so I have come to the conclusion that antitrust does far more harm than good and that we would be better off if we didn't have it at all, if we could get rid of it.

Other Chicago School members—including George Stigler—changed their views *a la* Friedman too. But those changes occurred more than a decade ago. Frankel Paul (2005) speculates that Hayek would have moved in a similar direction.⁵⁶

I have given some reasons why, if he was still alive today, Hayek may well have moved in my proposed direction. However, I have also provided some fundamental reasons why he would have been unlikely to move as far as I have. That's life!

Endnotes

- ¹ Paul Kerin, 'Rudd's blurred vision,' *The Weekend Australian* (20 October 2007). But I did vote for him!
- ² Paul Kerin, 'Busting the AFL cartel a worthy goal, but referee Samuel drops the ball,' *The Australian* (4 December 2007).

- ³ Paul Kerin, 'A whinge and a prayer,' *BRW* (13–19 October 2005); 'The sky's the limit,' *BRW* (20–26 October 2005); 'Good for Qantas, not good for us,' *BRW* (8–14 June 2006).
- ⁴ Paul Kerin, 'Price fixing and philanthropy go hand in hand: it's time to end the farce,' *The Australian* (16 October 2007).
- ⁵ Paul Kerin, 'A fine mess at AWB,' *BRW* (10–16 November 2005); 'Monopoly games,' *BRW* (2–8 June 2005); 'Singled out for criticism,' *BRW* (25 August–14 September 2005); 'Singularly unappealing,' *BRW* (21–27 April 2005) republished in *U.S. Wheat Letter* (28 April 2005); 'AWB & the single desk,' *Address to the Harvard Club of Victoria* (28 July 2006); 'AWB propaganda goes against the grain,' *The Australian Financial Review* (28 November 2006); 'Bitter harvest time,' *BRW* (23 February–1 March 2006); 'Desk has run its race,' *The Weekly Times* (6 September 2006) re-published in *Connections* (December 2006); 'Double standards on AWB's single desk,' *The Australian Financial Review* (10 October 2006); 'Sold out,' *BRW* (13 April 2006); 'States prove single desk wrong,' *BRW* (16 March 2006); 'Studies show competition beneficial to wheatgrowers,' *O'Connor Post* (30 May 2006), 'Time for a free wheat market,' *Address to the Australian Agricultural & Resource Economics Society (Victoria)* (March 2006); 'Time for a free wheat market,' *Address to the 'Friends of Agriculture'* (Canberra: Federal Parliamentarians, Parliament House, March 2006); 'Time for a free wheat market,' *Keynote Address to the W.A. Pastoralists' & Graziers' Association Annual Convention* (Perth: February 2006); 'Wheat deal under attack,' *BRW* (10–16 August 2006); 'Woolly thinking,' *BRW* (9 March 2006); 'A cure worse than the disease,' *The Australian Financial Review* (1 May 2007) republished in *Connections* (2007); 'Bold leadership needed on AWB morass,' *The Australian Financial Review* (17 April 2007); 'It's time Canberra brought the export wheat marketing farce to an end,' *The Australian* (17 July 2007); 'Labor may use its loaf to end Coalition's inept wheat marketing policy,' *The Australian* (20 November 2007); 'Minister marketing again the grain,' *The Australian Financial Review* (20–21 January 2007); 'More backwards than forwards,' *Address to the W.A. Pastoralists' & Graziers' Association Centenary Convention* (Perth: February 2007); 'Wheat industry grinds slowly on as single desk turns into a Frankenstein,' *The Australian* (5 September 2007) republished in *Connections* (September 2007).
- ⁶ Paul Kerin, 'AWB propaganda goes against the grain,' as above.
- ⁷ Paul Kerin, 'In fact, the wharfies were the bad guys,' *The Australian Financial Review* (29 May 2007).
- ⁸ Paul Kerin, 'Time to sell Australia Post,' *BRW* (21–27 July 2005).

- ⁹ Paul Kerin, 'Bad chemistry,' *BRW* (24–30 November 2005); 'High price of anti-competition,' *BRW* (30 June–6 July 2005).
- ¹⁰ Paul Kerin, 'Vegetable blight,' *BRW* (4–10 May 2006).
- ¹¹ Paul Kerin, 'The ASX is crying wolf in its strident bid to remain a monopoly exchange,' *The Australian* (18 March 2008); 'Do not pass go: time to tackle a monopoly that delivers outrageous profits,' *The Australian* (11 March 2008).
- ¹² Paul Kerin, 'Fare game in the taxi rip-off,' *BRW* (29 September–5 October 2005).
- ¹³ Paul Kerin, 'Break up Telstra,' *BRW* (12–18 May 2005); 'Labor's broadband intentions are good, but it's approach is misguided,' *The Australian* (18 December 2007).
- ¹⁴ Paul Kerin, 'Digital jam,' *BRW* (14–20 July 2005); 'Conroy tuned in to broadcast TV after Coalition's switched-off decade,' *The Australian* (11 December 2007).
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- ¹⁶ José A. Gómez-Ibáñez, John Meyer, Paul Kerin, and Leslie Dean, 'Deregulating and Privatising Urban Bus Services: Lessons from Britain,' *Report to the Urban Mass Transit Administration, US Department of Transportation* (September 1988).
- ¹⁷ Paul Kerin, 'Stop the drip,' *BRW* (6–12 July 2006); 'Big hole in PM's water plan,' *The Australian Financial Review* (7 February 2007).
- ¹⁸ Paul Kerin, 'Bracks gilds the WorkCover lily,' *The Australian Financial Review* (27 April 2004); 'How to cut the compo bill,' *The Australian Financial Review* (13 January 2004); 'Workers' compensation should be above politics,' *The Australian Financial Review* (16 July 2004); 'Workers' compo needs surgery,' *BRW* (3–9 March 2005).
- ¹⁹ Magazines and newspapers have obvious incentives not to publish criticisms of key suppliers (newsagents).
- ²⁰ See almost all of my previously cited articles.
- ²¹ Paul Kerin, 'A cure for cartel cancer,' *BRW* (25 January–1 February 2006); 'Price fixing and philanthropy go hand in hand,' as above.
- ²² When I became chairman, cartels operated in mosttrader categories (fruit and vegetables, deli, meat, seafood, etc). Prices were outrageously high. The cartels had persisted for many years. The main enforcement device was intimidation—of fellow traders, potential new entrants, management, board, and market owners. Various intimidation tactics were employed—physical threats, personal character assassinations in friendly media and, of course, appeals to government (both local and state). Introduction of very brave new traders in cartelised categories (in the face of enormous resistance and threats) generated substantial improvements.
- ²³ For brevity, I will use the term 'monopoly' very loosely to cover both the sell-side and the buy-side (monopsony).

- ²⁴ Kevin Rudd, 'How the tide is turning toward a social democratic alternative in Australian policy,' Speech to The Centre for Independent Studies (Sydney: 16 November 2006).
- ²⁵ See Paul Kerin, 'Rudd's blurred vision,' *The Weekend Australian* (20 October 2007).
- ²⁶ Hayek's frequent opponent (but also great admirer) John Maynard Keynes once replied to an accusation that he had changed his mind: 'When the facts change, I change my mind. What do you do, sir?' (quoted in Alfred L. Malabre, Jr., *Lost Prophets: An Insider's History of the Modern Economists* (Boston, Mass.: Harvard Business School Press, 1994)).
- ²⁷ Ellen F. Paul, 'Hayek on monopoly and antitrust in the crucible of *United States v. Microsoft*,' *New York University Journal of Law & Liberty* 1:0 (2005), 167–204.
- ²⁸ Ludwig von Mises, *Liberalism in the Classic Tradition* (1927) as translated by Ralph Raico (New York: The Foundation for Economic Education, 1985).
- ²⁹ Friedrich A. Hayek, *The Constitution of Liberty* (London: Routledge, 1960).
- ³⁰ William Baumol, 'Contestable markets: an uprising in the theory of industry structure,' *The American Economic Review* 72 (March 1982), 1–15; William Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* (San Diego: Harcourt, Brace Jovanovich, 1982).
- ³¹ For example, a regional monopolist exploiting the only supply of a resource in its region (although alternative supplies exist in another region) could charge higher prices in the region's interior and lower prices towards the edges to prevent entry.
- ³² Friedrich A. Hayek, *The Constitution of Liberty*, as above, 253–266.
- ³³ Ellen F. Paul, 'Hayek on monopoly and antitrust in the crucible of *United States v. Microsoft*,' as above, 176.
- ³⁴ Friedrich August Hayek, 'Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy,' *The Political Order of a Free People* Vol. 3 (University of Chicago Press, 1979), 84.
- ³⁵ As above, 85.
- ³⁶ As above.
- ³⁷ Friedrich A. Hayek, cited in Ellen F. Paul, 'Hayek on monopoly and antitrust in the crucible of *United States v. Microsoft*,' as above, 177.
- ³⁸ As above, 178.
- ³⁹ Friedrich August Hayek, *Law, Legislation and Liberty*, as above, 73.
- ⁴⁰ As above, 88.
- ⁴¹ This grossly understates the number of monopolies/cartels, as many of those industries involve multiple monopolies (when we dissect by geography, product or other dimensions).
- ⁴² Ludwig von Mises, *Human Action: A Treatise on Economics* (Yale University Press, 1949), 366.

- ⁴³ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* Vol. 1 (Edinburgh: T. Nelson and P. Brown, 1828), 54.
- ⁴⁴ As above.
- ⁴⁵ John M. Connor and Yuliya Bolotova, 'Cartel overcharges: survey and meta-analysis,' *International Journal of Industrial Organisation* 24:6 (November 2006), 1109–1137.
- ⁴⁶ The first 'learning' curve was not empirically estimated until 1970.
- ⁴⁷ For example, von Mises' dismissal of cartel persistence on the basis that each member has an incentive to 'cheat' is particularly valid if it is a 'one-shot' game. But cartels are potential multi-period games, where not cheating is valuable to build trust with other members and therefore sustain your share of cartel profits for longer.
- ⁴⁸ See, for example, John M. Connor and Yuliya Bolotova, 'Cartel overcharges,' as above, and John M. Connor, 'Price-fixing overcharges: legal and economic evidence,' *Research in Law and Economics* (2007), 22, 59–153.
- ⁴⁹ George Bittlingmayer, 'The antitrust Emperor's clothes,' *Regulation* 25:3 (October, 2002).
- ⁵⁰ Hiau Looi Kee and Bernard Hoekman, 'Imports, entry, and competition law as market disciplines,' *Policy Research Working Paper Series* 3031 (The World Bank, 2003).
- ⁵¹ John M. Connor and Yuliya Bolotova, 'Cartel overcharges,' as above.
- ⁵² John M. Connor, 'Price-fixing overcharges,' as above.
- ⁵³ As of the date of presentation, this legislation had not been passed; it subsequently was passed.
- ⁵⁴ See, for example, Caron Beaton-Wells, 'Cartel law could be dead letter,' *The Australian Financial Review* (11 March 2008) and Matt Drummond, 'Business urges Labor to go slow on anti-cartel bill,' *The Australian Financial Review* (10 March 2008).
- ⁵⁵ Milton Friedman, 'The Business Community's Suicidal Impulse,' *Cato Policy Report* 21:2 (March/April 1999).
- ⁵⁶ Ellen F. Paul, 'Hayek on monopoly and antitrust in the crucible of *United States v. Microsoft*,' as above.

The Jurisprudence of Friedrich A. Hayek

Suri Ratnapala

Friedrich A. Hayek is most famous for his work in economics and social theory. His important contribution to jurisprudence has largely been unnoticed in law schools but is better known in economics schools where the Austrian school has a presence. Hayek's jurisprudence is inseparable from his political economy and they combine to form his overall social theory. His views on law and justice arise from the same epistemology that informs his economic theory, namely, critical rationalism that recognises the irremediable limitations of human knowledge. According to this view, the rule of law is not simply a moral claim but a necessity for coping with the human condition in a world that is in permanent disequilibrium. There is no better theoretical explanation of the emergence and evolutionary rationality of the English Common Law than Hayek's account of it in *Rules and Order*, which is the first volume of his seminal work *Law, Legislation and Liberty*.¹

In *Rules and Order* (1973), Hayek explains the deep misunderstanding of the nature of human knowledge and reason that leads to misconceptions about order in the universe, the nature of law, and the misuse of legislative power. The second volume, *The Mirage of Social Justice* (1976), investigates the tribal roots of communitarianism and unmasks the true nature of political claims for equity and social justice. In the third volume, *The Political Order of a Free People* (1979), Hayek diagnoses the structural flaw in majoritarian systems that inevitably leads to the miscarriage of the democratic ideal and the systematic erosion of the conditions of freedom, and outlines his somewhat optimistic proposals for constitutional redesign.

The old division between positive and natural law

Hayek's jurisprudence cannot be appreciated fully without knowing something of the two persistent traditions in jurisprudence—natural law theory and legal positivism. The central idea of natural law theory is that a higher law exists independent of human authorship. This law dominated the legal thought of the ancient and medieval societies. This is the law that Aristotle equated to justice. This is Antigone's law, the universal and immutable principles that human law cannot abrogate.² Natural law theory became theological doctrine in the writings of Augustine, Aquinas and the later scholastics; was secularised by Grotius, Hobbes and Pufendorf; and entered modern constitutional theory through Locke's social contract hypothesis and Blackstone's *Commentaries on the Laws of England*. Natural rights as spelled out by Locke and Hobbes form the basis of the various national and international charters on human rights.

Natural law theory, despite its importance as a philosophical shield against the arbitrary power of rulers, has limited practical value in the daily lives of people. It does not help us identify the laws we must observe. It is unhelpful to the scientific understanding of the way laws emerge and change over time. The confusion of law and morality weakens the rule of law by causing legal uncertainty. Clarity and certainty of law became an urgent need in the new and rapidly growing commercial society of the eighteenth century. Utilitarians led by Jeremy Bentham dismissed natural law as fiction and proposed the positivist thesis that law is solely the creation of human lawmakers such as monarchs, dictators, parliaments and judges. Law and morality, they said, have only a contingent connection. Although many laws enforce moral rules of the society, a law does not cease to be law for failing some moral test.

Bentham is regarded as founder of British legal positivism, but the roots of this tradition go back to the *Leviathan* of Thomas Hobbes, who believed fervently in the natural rights of man but commended their protection to an absolute sovereign. Hobbes was dismayed by the destruction wrought by the English Civil War (1642–49) and the arbitrary rule of the Rump Parliament that followed the defeat and execution of Charles I in 1649. The turmoil

and chaos of those times convinced Hobbes that only a strong sovereign government can secure the safety and well being of the people. This meant acknowledging an 'uncommanded commander' whose will is law. He thought that this was the only means by which people can escape the state of nature in which the life of man is 'solitary, poor, nasty, brutish, and short.'³ However, Hobbes believed that a sovereign who fails to protect man's natural rights through weakness or corruption forfeits the right to rule. The idea of law as the command of the sovereign was embraced by Bentham, the first of the modern utilitarians. Bentham rejected the idea of natural rights as fictitious and argued that, for the sake of clarity and certainty, we must recognise as law only the commands of the established sovereign. He defined law as 'an assemblage of signs declarative of a volition conceived or adopted by the *sovereign*,'⁴ recalling the old maxim of royal absolutism: *Voluntas principis habet vigorem legis*. Modern British legal positivists such as Herbert Hart abandoned the idea that law is necessarily the command of a sovereign power. Law is not always found in the form of commands and, in modern constitutional states, there is no such thing as sovereign power. Hart, to his credit, acknowledged that the customary rules of primitive societies were laws. Yet, Hart and his followers retained the idea that law in a developed society is always the product of a human agent. This means that social rules are not laws unless 'legalised' by an authority competent to bestow formal validity upon them. Custom becomes law only when restated in legislation or transformed by courts into judicial precedent.

The positivist theory of law as a description of the 'lawyer's law' has value. Lawyers, in the normal course of advising clients and presenting legal arguments in courts, look to legislation and judicial precedents in the first instance. Courts in mature legal systems are usually not swayed by moral and policy arguments unless the law is capable of admitting them. The positivist approach to law promotes legal certainty and clarity *to a degree*. However, by identifying the law exclusively with state law, positivists gave a false account of law and banished from jurisprudence many rules on which the social and economic order and, hence, the authority of the state rests. Hayek argued that by obliterating

the distinction between law as rules of conduct and legislation directed to the achievement of particular ends, legal positivism has undermined an important condition for the prevalence of the rule of law.⁵

Epistemology of Hayek's jurisprudence

Hayek's theory of law is built ground upwards from a firmly laid epistemological foundation. The definitive statement of this theory is found in the three volumes of *Law, Legislation and Liberty*.

The great achievements of the Enlightenment had one unfortunate side effect. We gained a false sense of the power of reason. It made us think that all successful institutions are the products of reason and that there are no limits to what we can achieve by rational action. Legal positivism is an outgrowth of this mindset, which Hayek called 'constructivist rationalism.' Laws according to legal positivists are the products of rational minds, and law can be used to achieve all manner of ends that we desire. This ignores the fact that the fundamental laws that make social life possible—the laws that protect life, liberty and property and sanctify contracts—were not made but arose spontaneously as the result of accumulated human experience. They are, in Adam Ferguson's famous words, 'the result of human action, but not the execution of any human design.'⁶ They are respected not for their rationality but for the evolutionary advantages they conferred on groups that followed them. Critical rationalism, on the contrary, accepts the permanent limitations of human knowledge and recognises that human capacities can be extended by a reliance on grown practices and rules that embody accumulated wisdom. Take the practice of promise-keeping that arose long before there was any government to make law or enforce contracts. This simple rule allowed thousands of total strangers in many parts of the world to cooperate in producing the computer with which I write these words. This is the principle that Leonard Read demonstrated in his remarkable story, *I Pencil*.⁷

Hayek's epistemology is drawn from the work of Scottish moral philosophers, in particular David Hume, and like Hume, Hayek has been called an anti-rationalist. What Hayek condemned was naïve

rationalism. He was himself a rationalist in the sophisticated sense, which involves recognising the limits of reason.

Surely one of the tasks of reason is to decide how far it is to extend its control or how far it ought to rely on other forces which it cannot wholly control.⁸

There are three critical elements in Hayek's epistemology. The first is the rejection of Cartesian dualism, which is an inarticulate premise of constructivist rationalism. This is the view that there is a 'mind substance' independent of the environment and which enables persons with minds to design institutions and culture.⁹ Hayek pointed out that the mind is in fact an adaptation to the natural and social environment. 'The conception of an already fully developed mind designing the institutions which made life in society possible is contrary to all we know about the evolution of man.'¹⁰ This is an insight that evolutionary psychology now supports.¹¹

The second critical element of Hayek's epistemology is the 'primacy of the abstract.' Human beings think in categories. Terms such as 'dog,' 'cat,' 'fish,' 'vehicle,' 'food,' 'motorcar,' and 'aircraft' represent abstractions that allow us to communicate ideas without having to refer to every individual member of the class of things we are talking about. There is a belief promoted by constructive rationalism that abstractions are creations of conscious thought that we can dispense with as we like. Hayek argued that the reverse is actually the case—abstraction makes thought and action possible. Hayek, in his earlier work on theoretical psychology *The Sensory Order* (1952), had observed that the patterns of external stimuli that strike our sensory organs and then the central nervous system do not correspond exactly to the sensations that we ultimately feel. The central nervous system of the species and the individual has evolved through adaptation. It assigns different kinds of attributes to different kinds of sensory experiences that the individual organism receives. In other words, it puts certain kinds of sensory stimuli into certain kinds of classes. This is the process of abstraction.¹² Without such abstraction, there is no sensory order but only random impulses. The order created by this abstraction is the mind.

What we call 'mind' is thus a particular order of a set of events taking place in some organism and in some manner related to but not identical with, the physical order of events in the environment.¹³

What all this tells us is that we can never know the physical world in all its complexity, but we must rely on the abstractions that the central nervous system allows. The abstractions though are fallible. When we realise by experience that they misrepresent the world (in the sense that our actions fail), we modify them. However, we replace the failed abstraction with a modified or new abstraction. We do not, and cannot, abandon abstraction and start dealing in singularities. If we do so, we will literally lose our minds.

The third element of Hayek's epistemology relates to the complex and emergent nature of the physical and social environment in which we live. Nature and society are not static like paintings on canvas. They are ever-changing complex systems. They have what scientists call the quality of emergent complexity. There are two kinds of knowledge in relation to complex systems. One is about the processes and rules of the system. The other is knowledge that is peculiar to time, place and preference. It is possible to know at least in general terms the former kind of knowledge, but no single mind can command the latter kind. We can recognise the general rules that the elements of such a complex system obey but can never command all the information that is dispersed among the countless individual agents that make up a complex system. We observe, for example, that there is a general practice of exchange whereby individuals obtain the goods and services they need or desire. Yet, no one has knowledge of the individual needs and preferences of persons, the value that they place upon them, and what they are prepared to exchange. Political ideologies that favour central planning such as socialism and fascism proceed on the pretense that government has such knowledge. This is what Hayek calls the *synoptic delusion*.

The characteristic error of constructivist rationalists in this respect is that they tend to base their argument on the fiction that all the relevant facts are known to some one mind, and that it is possible

to construct from this knowledge of the particulars a desirable social order.¹⁴

Two kinds of order

The kind of constructive rationalism that Hayek condemns fails to appreciate that the universe is made up of two very different kinds of order. One is made order or organisation (*taxis*) and the other is spontaneous order (*cosmos*). The constructivist fallacy is to treat all successful institutions as purpose built and to think that things like morals, markets and legal systems can be engineered to our satisfaction without too many repercussions. On the contrary, customary morals, laws, markets and, indeed, language are self-ordering complex systems that no one has designed. Customary law and morals have histories that predate even the oldest political and religious authority. In fact, people observed rules long before they acquired language. As Hayek pointed out, 'Although man never existed without laws that he obeyed, he did, of course, exist for hundreds of thousands of years without laws he "knew" in the sense that he was able to articulate them.'¹⁵ Language itself is a grown order that has no author. Spontaneous order arises from the coincidence of behaviour of individual members responding to their local environment. The patterns of behaviour emerge insensibly through the process of selection. As Hume observed, 'rules of justice, like other conventional things, such as language and currency, arise gradually, and acquire force by a slow progression, and by our repeated experience of the inconvenience of transgressing it.'¹⁶ The grown rules form an emergent complex order.

Since a spontaneous order has no creator it has no specific purpose, although its existence allows different persons to pursue their separate ends. The law of contract has no purpose. Yet, all persons use that law for all kinds of private purposes from buying a bus ticket, to going to the cinema, getting medical treatment, going on vacation, effecting a corporate takeover, and satisfying innumerable individual needs and wants.¹⁷ Reliance on spontaneous order such as the grown law or the market allows people to extend their capacities. I do not have to know

medical science to cure my illness or accounting to do my tax returns because the general and impersonal rules of law allow me to engage others who have the knowledge.

In contrast, an organisation has a creator and a purpose. They are effective for certain kinds of projects where the purposes are known and the organisers possess necessary resources and knowhow. If the purpose is to win a war or a football competition, operate a supermarket or a university, or mine minerals in the outback, then create an organisation. Constructivist fallacy obscures the difference between organisations and grown order. Command and control works for an organisation but is hopelessly misconceived in relation to systems that exist because of the actions of multitudes of individual agents in responding to local stimuli. A central controller can never command all the bits of knowledge scattered among millions of actors—the knowledge special to time and place and the individual. This is why command economies fail. The dynamic spontaneous order that bears the name society functions best when its individual members can use their knowledge for their own purposes subject to general and impersonal rules of conduct.

Two kinds of rules and of law

The failure to distinguish between *cosmos* and *taxis* leads to another serious confusion. Order, whether designed or spontaneously grown, is based on rules. An organisation that has no rules will be disorganised and ineffective. An organisation that is rule bound will be inflexible and ineffective. However, the rules of an organisation are purpose oriented and yield to managerial discretion. An army that is strictly governed by general rules of battlefield conduct is likely to be vanquished. A commercial enterprise unwilling to do *ad hoc* deals with others will suffer a similar fate. The rules of an organisation are rules of convenience deliberately made by the organisation to serve its purposes. Hence, they belong to the old Greek category of *thesis*. It must be noted though that the rules of some organisations, such as those of incorporated and unincorporated associations, are partly in the nature of contract. They determine the rights and duties of the members and managers. Nevertheless, many of the rules will leave

wide discretion with managers to formulate and pursue corporate strategies.

The rules of a grown order (*cosmos*) are of a different character. Since it has no creator and no purpose, it does not serve particular ends. They grow out of the commonalities in the behaviour of individuals. Its rules are general and impersonal and usually negative in effect. These rules are what the Greeks called *nomos*. It is important to understand why these rules are necessarily abstract and impersonal. Distillation through experience is a process of generalisation or abstraction. As Hayek noted, the fruits of experience are preserved ‘not as a recollection of particular events, or explicit knowledge of the kind of situation likely to occur, but as a sense of the importance of observing certain rules.’¹⁸ A rule of conduct can be universalised only in the negative form unless the rule relates to a very narrow type of circumstance. It is impossible to express the rules against murder, rape, theft, trespass, and non-performance of contracts in positive terms if they are to protect all persons living and yet to be born. Universality can be achieved only by the ‘Thou shall not ...’ formula. Even when it appears that a rule requires positive action, closer examination will show it to be capable of negative formulation. The rule that requires contracts to be performed is a rule that prohibits actions in breach of contract. The rule that requires a surgeon to provide post-surgical care to a patient is actually an application of the rule against negligent omission measured by the standard of care expected of a surgeon. Even in the rare cases where the common law imposes positive duties, such as the seafarer’s duty of rescue at sea, there is a special relationship at play where the duty bearer is in a unique, and hence, quasi-fiduciary position in relation to the beneficiary. The rule can be generalised into the injunction: ‘Do not abandon a person whose life uniquely depends on you, if you can save him without endangering your own life.’

Hayek sees in the common law a shining example of spontaneous order. His explanation of the role of the judge stands as the finest theoretical exposition of common law adjudication. The common law’s custom based rules adjust gradually to the changes in the factual order of society through the process of adjudication by impartial

judges. Judges, when they act as they should, maintain the ongoing order. Their job is maintenance, not construction. The general opinion popularised by Bentham that common law judges make law for the individual case is plainly wrong. The cases are illustrations of general rules that guide the decision. It is part of the technique of the common law judge 'that from precedents which guide him he must be able to derive rules of universal significance which can be applied to new cases.'¹⁹ The common law judge, contrary to positivist theory, is not a deputy legislator with delegated legislative power. The question that the judge must decide is 'not whether the parties have obeyed anybody's will, but whether their actions have conformed to expectations which other parties have reasonably formed because they correspond to the practices on which everyday conduct of the members of the group was based.'²⁰ Thus, the judge's duty is to uphold legitimately held expectations formed in reliance of the social practices and rules. A judge, in deciding what expectations are reasonable, 'can take account only of such practices (customs or rules) as in fact could determine the expectations of the parties and such facts as may be presumed to have been known to them.'²¹ There are of course 'hard cases' where spontaneously grown rules collide or the application of the rule to new conditions is not clear. Even here, the judge's task is not to impose his preference but to adjust or supply a rule that is in harmony with the cosmos of rules within which he works. The judge's aim is not radical change but incremental improvement through 'immanent criticism.'²²

This idealised version of common law is not fully borne by legal history. Judicial activism in the seventeenth century helped break down monopolies, limit royal legislative prerogatives, secure the immunity of jurors from Crown prosecution, and in numerous ways free commerce from ancient constraints. These were critical factors in the growth of constitutional government and the free market in England. In modern times, we see judicial activism of another kind where judges introduce values drawn from international treaties and their own notions of social justice in shaping common law. Yet, Hayek's general point is historically valid. Common law remains a self-ordered system of generally predictable rules that secures an unprecedented degree of individual freedom.

Rise of legislation

Common law's capacity to maintain the rules of the free market was weakened by the incessant legislative interventions of modern democracy. Hayek accepted the need for legislative correction of common law when it is clearly miscarried or when response to rapid change is required.²³ Parliament can do this without destroying the general and impersonal character of the system of rules under which freedom and commerce thrive. However, in the age of mass democracy and all-powerful parliaments, legislative power has become the currency for gaining and retaining political power. The historical role of parliament, which is to make general laws for the community, is compromised by the need to satisfy particular interests of voting groups, without whose support majority parties cannot remain in office. Hayek attributes the present state of democracy and the rule of law to two monumental intellectual errors.

The first was the false identification of law with legislation. In classical thinking, a law is a general rule of conduct distinguished from commands directed to particular ends. It is the supremacy of this kind of law that makes possible freedom under law. In the era of legislation, law has become whatever that is commanded by a legislator. Today, a legislature is not so called because it makes laws but laws are so called because they are made by a legislature. This situation was compounded by another profound error concerning the true purpose of the separation of powers. The separation of powers was designed to achieve the rule of law by subjecting both rulers and citizens to a regime of generally accepted rules of conduct. This is possible only where the legislature is not omnipotent but confined to the making of general laws. These constraints, which even the sovereign British Parliament observed in practice, disappeared with the rise of the false faith in elected majorities. Even the constitutionally entrenched tripartite separation in the United States has been seriously weakened by the power of factions.

Hayek makes an invaluable contribution to constitutional theory by exposing the reason why the tripartite separation of powers is an insufficient safeguard of the rule of law. The essential point is that the effectiveness of the separation of powers for securing freedom under

law depends on how those powers are defined. If legislative power is not limited to the making of general rules, it becomes a source of arbitrary power. By itself, the tripartite separation of powers does not prevent this. In *The Political Order of a Free People*, Hayek proposes a new constitutional settlement. I will return to this topic after discussing Hayek's message in the second volume.

In an autocracy maintained by brute force, rulers do not have to justify their actions. In a democracy, rulers cannot be seen as callously partisan. Sectarian claims therefore take the form of appeals to social or distributive justice. Hayek argues that the concept of social justice involves a serious category error. According to the traditional concept of legal justice, a person's conduct is unjust if his action is contrary to a rule of conduct. No question of injustice can arise where no individual is responsible for the misfortune of another. That a man is poor is a matter for regret but it is not a matter of injustice unless his poverty was caused by some act such as robbery. The consequences that result from the functioning of the spontaneous order cannot be regarded as just or unjust. Hayek wrote:

It is the sign of the immaturity of our minds that we have not yet outgrown these primitive concepts and still demand from an impersonal process which brings about a greater satisfaction of human desires than any deliberate human organisation could achieve, that it conform to the moral precepts men have evolved for the guidance of their individual actions.²⁴

Hayek's argument is that in a market order, social justice has no meaning, and that it is not possible to preserve such order by imposing upon it an officially determined pattern of remuneration based on performance or need. The notion that we can ascertain the 'value to society' of a person's work makes no sense because things have value only to persons, and different persons within society value things differently.²⁵ Hayek was not opposed to social security against severe deprivation through an assured minimum income. There may be a moral duty on all to assist those who cannot help themselves for

reasons such as disability or age.²⁶ He thought such a social security system can be devised without limiting freedom and violating the rule of law. This is at odds with the libertarian view that only voluntary or private social insurance would not violate individual rights and liberties.²⁷ In any case, social justice has gone far beyond this aim and has become the pretext for wealth re-distribution and wealth equalisation by the socialists.

Curing the fatal flaw

In *The Political Order of a Free People*, Hayek returned to the fatal flaw in the constitutional arrangements of modern democracies, namely, unfettered legislative power. Hayek proposed a model constitution. He did not expect the established constitutional democracies to embrace this but hoped that it may be considered by new democracies and illustrate the key ideas of his theory. The central feature of Hayek's model is a new division of powers between a legislative assembly and a governmental assembly. The legislative assembly alone will have the competence to make or change laws and, importantly, law will mean general and impersonal rules. The enactments of this assembly are judicially reviewable by a constitutional court against the test of generality.²⁸ Hayek believed that such a limitation will be more effective than a traditional bill of rights. Apart from judicial review, Hayek proposed a second type of assurance by the way this assembly is elected. Since these legislators have no power to satisfy sectarian demands, Hayek expected that the electorate will tend to choose men and women on whose judgment of right and wrong they can depend. However, Hayek's proposal was to elect persons of mature age for long terms of say 15 years. They cannot seek re-election (to limit exposure to sectarian influence) but will be provided secure retirement. The governmental assembly will also be elected but, unlike current lower houses, will only exercise executive power subject to the general laws determined by the legislative assembly.

Hayek's model makes sense in theory, but the prospects for its adoption anywhere are remote. All the same, the central aim of

confining lawmakers' distributional powers as a means of restoring freedom under law cannot be abandoned by liberals. In the classical age of the English Constitution, the House of Lords provided a significant restraint on the House of Commons, who were moved by the passions of the newly enfranchised electorate. The upper houses of modern legislatures no longer act as non-partisan houses of review. A realistic program of liberal constitutional reform may start by making the case for de-politicising upper houses.

Endnotes

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- ⁵ Hayek, note 1, 44–48
- ⁶ Adam Ferguson (1767), *An Essay on the History of Civil Society* (Edinburgh: Edinburgh University Press, 1966), 22.
- ⁷ *I, Pencil: My Family Tree* as told to Leonard E. Read, www.econlib.org/LIBRARY/Essays/rdPncl1.html.
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- ¹¹ Leda Cosmides and John Tooby, 'The Psychological Foundations of Culture' in Jerome Barkow, Leda Cosmides, and John Tooby (eds), *The Adapted Mind: Evolutionary Psychology and the Generation of Culture* (New York, Oxford University Press, 1992).
- ¹² Friedrich A. Hayek, *The Sensory Order* (Chicago: University of Chicago Press, 1952), 166; Friedrich A. Hayek, *Law, Legislation and Liberty* Volume I (London: Routledge, 1973) note 1, 30.
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- ¹⁴ As above, 14
- ¹⁵ As above, 43
- ¹⁶ David Hume, *Enquiries Concerning Human Understanding and Concerning the Principles of Morals* (third edition) (Oxford: Clarendon Press, (1975[1748]) 490).
- ¹⁷ Friedrich A. Hayek, *Law, Legislation and Liberty* Volume I, as above, note 1, 39.
- ¹⁸ Friedrich A. Hayek, *Law, Legislation and Liberty* Volume 2, as above, note 1, 4.
- ¹⁹ Friedrich A. Hayek, *Law, Legislation and Liberty* Volume I, as above, note 1, 86.
- ²⁰ As above, 96.
- ²¹ As above, 86.
- ²² As above, 118.
- ²³ As above, 88.
- ²⁴ Friedrich A. Hayek, *Law, Legislation and Liberty* Volume 2, as above, note 1 63.
- ²⁵ As above, 76.
- ²⁶ As above, 87.
- ²⁷ Robert Nozick, *Anarchy, State and Utopia* (New York: Basic Books, 1974), ix.
- ²⁸ Friedrich A. Hayek, *Law, Legislation and Liberty* Volume 3, as above, note 1, 121.

The Liberal Philosopher's Trap*

Sinclair Davidson

Friedrich A. Hayek has received a lot of uncomplimentary press in recent times. Labor's Kevin Rudd has taken it upon himself to engage 'the right' in a values debate—with his chosen battleground being Hayek's legacy. According to Rudd in a recent commentary—an abridged version of which appeared in the *Australian Financial Review* on 17 November 2006—Australia, the United Kingdom, and the United States have been in the grip of a 'Hayekian economic revolution' and 'the radicals have won and won consistently.'¹ A 'minority intellectual sect' has had a 'profound effect on the politics, public policy and even foreign policy of much of the collective West.'² Rudd provides a social democratic response to Hayek's stark vision of human nature and his unfettered market. We are treated to an explanation of Hayek's philosophical beliefs and how this world vision has been imposed upon Australia. But in order to pursue his critique, Rudd misquotes and misinterprets Hayek's arguments and views.

Hayek is famous for *The Road to Serfdom* (1944), undoubtedly his most influential work, but *The Constitution of Liberty* (1960) is probably his best. He won the Economics Nobel Prize in 1974, jointly with Gunnar Myrdal, for his 'penetrating analysis of the interdependence of economic, social and institutional phenomena.'³ The Nobel citation coyly speaks of his work 'with regard to basic difficulties in "socialistic calculating".' In layman terms, Hayek identified the reasons why Marxist socialism would fail. Socialists of all breeds have never forgiven him.

* This is a fully referenced version of a paper that appeared in the *Australian Financial Review* on 15 December 2006, Review Section page 3, © 2006 Copyright John Fairfax Holdings Limited.

The citation also briefly mentions his theory of information and knowledge. Yet it is this theory, set out in two papers in 1937 and 1945, that underlies Hayek's lasting contribution.⁴ He thought so too; his Nobel lecture was titled 'The Pretence of Knowledge.' Hayek's insight is that nobody knows everything. There is 'a sum of facts which in their totality cannot be known to the scientific observer, or to any other single brain.'⁵ Knowledge does not exist in 'concentrated or integrated form' but is dispersed, incomplete and even contradictory.⁶

The consequences of this insight are fundamental and profound. In his Nobel Prize lecture, Hayek concludes with a warning:

If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that ... he cannot acquire the full knowledge which would make mastery of the events possible ... The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals.

In Hayek's vision, socialists of every kind strive to control society and so undermine entrepreneurship and economic prosperity. It is not surprising that Rudd singles out Hayek for abuse, for Hayek provides a powerful and damning indictment of the social democratic experiment.

Hayek on political economy

Rudd describes Hayek as having a technocratic concept of politics; his political economy is dismissed as being 'completely off the planet.'⁷ Yet, Rudd does not thoroughly explore Hayek's ideas on political economy—many of which are mainstream; indeed, Rudd should approve of them.

Hayek's political economy has two important, related ideas. Hayek is a classical liberal; he defines liberalism as a doctrine that promotes limited government. Democracy is a mechanism for making choices and decisions. Critics, such as Rudd, spend too much time on Hayek's critique of democracy and too little on his defence of democracy.

Hayek both opposes unlimited government and dogmatic democrats.⁸ Rudd also opposes unlimited government; in an essay in the *The Monthly*, he criticised the Howard government for using its Senate majority to 'legislate away a century of hard-won protections.' Further, he lauded the fact that government was unable to pass asylum-seeker legislation.⁹ Hayek is quite clear where he stands; Rudd is confused. Does he support limited government or not? How is his position different from Hayek's position?

In *The Constitution of Liberty*, Hayek provides an insightful discussion on democracy and majority rule.¹⁰ His critics are unlikely to have read beyond the early pages. Democracy is a means to an end, not an end. In these politically correct days, it is heresy to suggest this, but Hayek is unapologetic. He is a strong proponent of democracy: 'It is probably the best method of achieving certain ends whenever coercive rules have to be laid down, the decision ought to be made by the majority.'¹¹ Who could disagree? The question, however, is when should coercive rules be laid down? The answer is embedded in Hayek's defence of democracy.

Hayek produces three, individually conclusive, arguments in favour of democracy.¹² First, democracy is 'the only method of peaceful change' known to man. Second, democracy is a safeguard of individual liberty—yet it is not in and of itself liberty. Third, democracy is a 'process of forming opinion.' Government must appeal to views and opinions beyond itself when proposing policy. If government opinion strays too far from that of the electorate, it will lose office. Hayek is clear: democracy is the preferred system of government in the long run due to its dynamic aspects. In the short run, democracy may not be superior to other systems of government—it does not place power in the hands of the elite or the wisest or the best informed.

Those who would form government have to convince a large diverse group of individuals to vote for them. The minority has to convince

the majority. This is more likely to occur in an environment of limited rather than unlimited government, which is the enemy of liberty: 'A democracy may well wield totalitarian powers, and it is conceivable that an authoritarian government may act on liberal principles.'¹³

Contrary to Rudd's implication, Hayek supports democracy and limited government. Where Rudd particularly misrepresents Hayek is on government policy. What does limited government mean? Rudd tells us that Hayek is an 'unrepentant social engineer' who does not value altruism or the family, who offers no explanation of the proper role of public goods, and who is opposed to public education. He tries to differentiate Hayek from Adam Smith on the question of public goods, saying Smith supports public education whereas Hayek does not. But as I show below, this is not an accurate interpretation of Hayek's position.

Adam Smith prescribes three governmental functions: national defence, the administration of justice, and public works 'which though they may be in the highest degree advantageous to a great society, [they] are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals.'¹⁴ Smith, however, provides a strong caveat to his public goods argument: these public works exist chiefly to 'facilitate the commerce of society' and 'instruction of the people.' Rudd approves of Smith but not Hayek. But what does Hayek say?¹⁵

I should correct a widespread misunderstanding. The basic principle of the liberal tradition, that all the coercive action of government must be limited to the enforcement of general rules of just conduct, does not preclude government from rendering many other services for which, except for raising the necessary finance, it need not rely on coercion ... I am the last person to deny that increased wealth and the increased density of population have enlarged the number of collective needs which government can and should satisfy.

Contrary to Rudd, Hayek does not oppose all government intervention in the economy. Indeed, as he writes in *The Constitution*

of *Liberty*, 'it is the character rather than the volume of government activity that is important. [A] government that is comparatively inactive but does the wrong things may do much more to cripple the forces of a market economy than one more concerned with economic affairs but confines itself to actions which assist the spontaneous forces of the economy.'¹⁶

According to Hayek, there are at least four areas where government action can occur.

1. Where the market would not provide any service, for example, 'a reliable and efficient monetary system,' 'setting of standards of weights and measures,' 'land registration, statistics, etc.' Hayek includes 'the support, if not also the organisation, of some kind of education.'¹⁷
2. Those services that are clearly desirable, including 'most sanitary and health services, often the construction and maintenance of roads, and many of the amenities provided by municipalities.'¹⁸
3. Other activities such as to 'encourage the advancement of knowledge.'¹⁹
4. General regulation is a legitimate function of government. Indeed, he says, 'We are not concerned here with the question of whether such regulations will be wise, which they probably will only be in exceptional cases.'²⁰ Hayek provides a detailed justification for government activity in the economy and provides concrete examples. Nowhere in his recent attacks on Hayek do we see any evidence that Rudd is aware of this discussion.

Hayek does not grant government *carte blanche* in where and how it intervenes in the economy. For example, government intervention would be incompatible with liberal principles if it were to operate a monopoly and so inhibit innovation, if taxes were not raised on uniform principles but used to redistribute incomes, and if government satisfied the wants of narrow interest groups.²¹ Australian government often runs foul of these principles. In particular, taxes in Australia are not raised on uniform principles, and redistribution of income is bipartisan policy.

Hayek on social justice

Hayek is particularly hostile to the notion of 'social justice.'²²

[T]he phrase 'social justice' is not, as most people probably feel, an innocent expression of good will towards the less fortunate, but that it has become a dishonest insinuation that one ought to agree to a demand of some special interest which can give no real reason for it ... [P]eople should recognize that the term is intellectually disreputable, the mark of demagoguery or cheap journalism which responsible thinkers ought to be ashamed to use because, once its vacuity is recognized, its use is dishonest.

Hayek has a complex and detailed explanation as to why government cannot deliver social justice. This explanation is intimately related to his theory of information and knowledge. Free markets and free market prices make the best use of dispersed knowledge and information. Government can never have enough information, or knowledge, to copy or replicate the market.²³

When governments started to falsify the market price signals, whose appropriateness they had no means of judging (governments as little as anyone else possessing all the information precipitated in prices), in the hope of thereby giving benefits to groups claimed to be particularly deserving, things inevitably started to go wrong.

Hayek had made a similar argument in the 1930s during the so-called socialist calculation debate. Social justice as a principle fails for the same reason socialism failed. Social justice is not only impossible to achieve, it also involves principles inconsistent with liberalism.²⁴

Differences in wealth, education, tradition, religion, language or race may today become the cause of differential treatment on the pretext of a pretended principle of social justice or of public necessity.

Once such discrimination is recognised as legitimate, all the safeguards of individual freedom of the liberal tradition are gone.

In short, only an omniscient, omnipotent government pursuing neo-apartheid policies of discrimination among its citizens could ever hope to implement policies that would lead to social justice. Despite this condemnation, it is Rudd who describes Hayek as being an ‘unrepentant social engineer.’ Rudd supports his assessment with the following quote:²⁵

Rational behaviour is not a premise of economic theory, though it is often presented as such. The basic contention of theory is rather that competition will make it necessary for people to act rationally in order to maintain themselves. Competition is as much a method for breeding certain types of mind as anything else ...

This quote is manufactured. What Hayek actually wrote is quite different. Rudd has omitted the first word of the first sentence—‘But.’ Hayek is making a general point about causation, not social engineering. The first two sentences of the quote come from page 75 of *The Political Order of a Free People*.²⁶ The third sentence in Rudd’s quote comes from page 76 (and is only half quoted), one paragraph and eight sentences later. At that point, Hayek is speaking about entrepreneurial behaviour and how it responds to the business environment. People respond to incentives, hardly a radical notion—yet Rudd’s readers would form a very different understanding.

Hayek, family and religion

Rudd argues that there is a split in the Right between liberals and conservatives, that Christians should be uncomfortable with Hayek’s views on markets, and that Hayekian market principles are anti-family. Rudd’s critique of Hayek and Christianity is very weak and consists of a warning that ‘Christian enthusiasts should reflect carefully’ on the Hayekian agenda. Indeed, they should.

Hayek was not a believer—although he did receive the last rites of the Catholic Church prior to his death, and there is a cross on his tombstone in Vienna.²⁷

In his opening address to the Mont Pelerin Society, Hayek laments the 'intolerant and fierce rationalism' that had 'driven religious people from the liberal movement.'²⁸ He also included an entire chapter on religion in his last book, *The Fatal Conceit*. Rudd cites that book but not the chapter. Hayek is sympathetic to religion.²⁹

We owe it partly to mystical and religious beliefs, and, I believe, particularly to the main monotheistic ones, that beneficial traditions have been preserved and transmitted ... even an agnostic ought to concede that we owe our morals, and the tradition that has provided not only our civilisation but our very lives, to the acceptance of such scientifically unacceptable factual claims.

In Hayek's worldview, religion plays a very important role, but not all religions play that role—the only religions that have survived are those which support property and the family.³⁰ Hayek is supportive of the role of the family, and he does not exclude it from his 'spontaneous, self-generating market-based order,' as Rudd alleges.³¹ Hayek indicates, 'society is made up as much of families as of individuals.'³²

Rudd asks 'what "moral" gift is useful for our children given the amorality of the [Hayekian] market order where rational self-interest alone is to prevail?'³³ For a start, the work ethic is a valuable moral gift. But Hayek goes beyond that and points to 'morals, tastes and knowledge' and more 'parents can do more to prepare their children for a satisfactory life than anyone else.'³⁴ This must be a strange notion to Rudd, who subscribes to community and solidarity. This, of course, is Hayek's very fear about social justice; the individual is subsumed into the collective.

Rudd makes much of the fact that Hayek believes family values are distinct from market values. Indeed, Rudd argues that Hayek fails to properly explain how the two can be kept separate. Yet, Hayek discusses these issues at length in his lectures ‘The Mirage of Social Justice’ (1976), ‘The Atavism of Social Justice’ (1978), and ‘The Fatal Conceit’ (1979)—works that Rudd cites in his paper. Further, Rudd tells us that Hayek breaks from Adam Smith, yet Hayek’s argument builds on Smith’s notion of the invisible hand and the division of labour.

The human condition has evolved rapidly from groups of individuals who had mutual obligations and food sharing arrangements to one where individuals trade with each other.

If all people shared, and did not trade, our standard of living would be a lot lower than its current levels. Hayek makes the simple argument that if we treated our trading partners as we do family members, all trade would halt. Similarly, if we treated our family members as we do our trading partners, the family unit would become unstuck.

Hayek values the family as a social institution, yet Rudd suggests he favours the ‘commodification and marginalisation of all human relationships, including family relations.’³⁵ That is simply false. Both Rudd and Hayek believe family values and market values should be kept separate. Yet for Rudd, that separation can exist only when government legislates to protect working conditions.³⁶ Hayek has parents playing a role in determining the interests of the family and children.

Conclusion

Kevin Rudd wishes to engage the Right in a debate on values. That is his job. It is not clear, however, that he has chosen his battleground carefully. He has not understood, or even discussed, the essential elements of the Hayekian orthodoxy, which revolve around dispersed information and knowledge.

Rudd should approve of Hayek’s concern about unlimited government, and his robust defence of democracy as a dynamic

institution. Contrary to Rudd's assertions, Hayek, unlike many non-believers, is sympathetic to religion, in particular, the monotheistic religions.

Further, Hayek has a lot to say about government intervention in the economy and is not inherently hostile to government *per se*. Indeed, he justifies more intervention than does Adam Smith. Where Hayek and Rudd part company is in the notion of social justice. Hayek is brutal in his rejection of that principle; it is unworkable and immoral.

It is clear that the Left need to engage in some ideas, it is not clear that attacking a straw Hayek will advance their cause very far. Hayek may well be widely quoted but, unfortunately, he is not widely understood. Rudd's efforts are proof of this point.

Endnotes

- ¹ Kevin Rudd, 'What's wrong with the right: A social democratic response to the neo-liberals at home and the neo-conservatives abroad,' Speech to The Centre for Independent Studies, http://parlinfo.aph.gov.au/parlInfo/download/media/pressrel/BBHL6/upload_binary/bbhl64.pdf;fileType=application/pdf (Sydney: 16 November 2006), 3.
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- ²⁴ Friedrich A. Hayek, ‘Economic freedom and representative government,’ as above, 110.
- ²⁵ Kevin Rudd, ‘What’s wrong with the right,’ as above, 4.
- ²⁶ Friedrich A. Hayek, *Law, Legislation and Liberty: The Political Order of a Free People*, Volume III (Chicago: Chicago University Press, 1979).
- ²⁷ Samuel Gregg, personal correspondence.
- ²⁸ Friedrich A. Hayek, ‘Opening address to a conference at Mont Pelerin,’ *Studies in Philosophy, Politics, and Economics* (Chicago: University of Chicago Press, 1967), 155.
- ²⁹ Friedrich A. Hayek, *The Fatal Conceit: The Errors of Socialism* (Chicago: University Of Chicago Press, 1991), 136–137.
- ³⁰ As above.
- ³¹ Kevin Rudd, ‘What’s wrong with the right,’ as above, 5, 11.
- ³² Friedrich A. Hayek, *The Constitution of Liberty*, as above, 79.
- ³³ Kevin Rudd, ‘What’s wrong with the right,’ as above, 11.
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- ³⁵ Kevin Rudd, ‘What’s wrong with the right,’ as above, 6.
- ³⁶ Kevin Rudd, ‘Howard’s brutopia,’ as above, 49.



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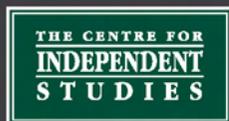
The Multi-layered Hayek

Friedrich August von Hayek was one of the intellectual giants of the 20th century. His contributions ranged from economics to philosophy, from law to psychology. In 1972, he won the Nobel Prize in Economics, and his ideas had great influence on politicians like Ronald Reagan and Margaret Thatcher.

At an event hosted by The Centre for Independent Studies in 2008, four academics delivered an assessment of Hayek's contributions to different fields of research and analysed their relevance to contemporary debates. This collection of essays demonstrates how much a source of inspiration Hayek's works still are.

Hayek was the central pioneering figure in changing the course of thought in the twentieth century.

— Thomas Sowell



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