Hayek – With an Eye to the Future

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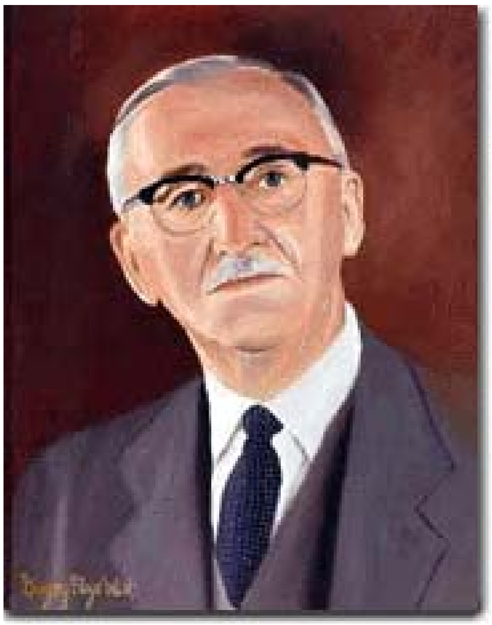
Forbes/ Forbes Global/ Cover Article/ May 1999



In his best-known book – *The Road to Serfdom* – published in 1944, Hayek predicted with devastating accuracy the consequences of socialist, Soviet-type economies. Those who discover the book now, after the fall of communism, may well ask themselves: This is so clear, how come most economists, political scientists, politicians, and the CIA failed to see this and were led astray?

And led astray they were. As late as 1984, John Kenneth Galbraith, the Harvard-based economist, wrote in the New Yorker that the Soviet economy was making great material progress. His evidence was the apparent well being of the people on the street, the rush-hour traffic, and the spread of apartment houses. He attributed the success to the fact that, in contrast with western economies, the Soviet system made full use of its manpower. Happiness through job security.

Galbraith was by no means alone among prominent economists to hold such views.

For decades, until the 11th edition, MIT's economics Nobel laureate Paul Samuelson, on whose textbook generations of practicing economists were raised, was telling students that it is a "vulgar mistake to think that most people in Eastern Europe are miserable." The 11th edition of the book deleted the word "vulgar." The twelfth edition, appearing in 1985, finally omitted the sentence. He substituted it with the question whether the economic gains achieved under communism were worth the political repression – a euphemism for the tens of millions killed, starved to death, put randomly in prisons for days and years of torture, which he failed to mention in the textbook. The textbook then claimed that this cost-benefit analysis is among the most "profound dilemmas of human society."

So much for the profound thinking of Mr. Samuelson, considered the father of modern economics. And yet, for 40 years, Mr. Samuelson's textbooks became the standard, and Hayek's writings have been little more than footnotes. Whether or not these views or self interest shaped the CIA's overblown estimate of the Soviet Union's power, historians will decide. Certainly, these economists' views of what can be achieved by centralized economics, masquerading as "science," didn't hurt.

Hayek was right not only about the "Errors of Socialism," the subtitle of another of his books, The Fatal Conceit. He was right on a range of narrower issues as well. He debated Keynes and the Keynesians – mainly the latter. On each and everyone issue Hayek's analyses stood the test of times, whereas the Keynesians' did not.

Before looking at these issues, a note. There is a reason I distinguish between Hayek debating the pragmatic, non-academic Keynes, and his followers. In a rarely quoted conversation between Hayek and Keynes, the former asked if he was not upset about the ways in which his followers were applying his ideas. Keynes answered: "Oh, they are just fools." (Unfortunately, though Keynes promised to put his revised views in writing, he died before having time admit in writing the errors of his ways. Though, after the Second World War, he never used either the theory or the language of what later came to identify "Keynesians.")

Now back to the issues. Starting with the end of World War Two, Keynesians advocated that governments can shape policies by looking at backward looking, aggregate numbers such as GNP (Gross National Product), aggregate investments, national savings and others. Within their models depressions happen because of "animal spirits," that is, people's inexplicable mood swings from optimism to pessimism. But – hold your breath – the wise Keynesian politicians and bureaucrats look at the numbers churned out by government bureaus of statistics, and know how and when to compensate for the riffraff's mood swings. When people turn pessimistic, governments stimulate “aggregate demand” by increasing public spending and printing more money. When “too many” people are employed and inflation becomes a threat, the state cuts spending and closes the money supply spigots. By artfully pulling and pushing these fiscal and monetary levers, the Keynesians argued, politicians could (and should) fine tune the economy keeping it in a state of fully employed, non-inflationary Keynesian paradise.

Rubbish, said Hayek, and he wrote about the "Misuse of Aggregates," be they about investment or price levels. And it is rubbish not only because aggregate, backward looking numbers mislead, but also because people, though each one makes mistakes, do not turn pessimistic or optimistic all at once. He also wrote that there is no way bureaucrats would know how to make intelligent spending and investment decisions, since they lack the deep knowledge that can come only from constant trial and error by millions of individuals over decades and centuries. In a series of writings – "Economics and Knowledge," "Competition as a Discovery Procedure," "The Pretence of Knowledge" – Hayek exposed the arrogance and conceit of politicians and social scientists who believed their knowledge was superior to the accumulated experience of the vast numbers of people whose knowledge is reflected in created new businesses and new markets. The creation of a liquid “junk bond” market, of leveraged buy-outs, both of which created a market for corporate control illustrate one facet of Hayek’s process of discovery. Steve Jobs, Bill Gates and Michael Dell reflect another.

Still another facet of Hayek’s view that spontaneous formations are superior to central direction is reflected now daily on the Net, which has significantly lowered the costs of creating new markets. The auctions offered by eBay and Amazon, or the new mini-Nasdaqs, such as offered by Chemdex, also illustrate Hayek’s view how discoveries – technological ones – allow dispersed knowledge to be absorbed rapidly, and how new knowledge is, in turn, being created. To put it another way: Hayek demonstrated that there is no way that a bureaucrat armed even with the most powerful computer could ever know how to price chickens, wheat, eggs, highways, schools, water and bonds better than the millions of self-interested human beings who trade daily in these items.

Keynesians thought they knew better. And, if push comes to shove, politicians – with Keynesian advisers, of course – also knew how to manipulate monetary policy. Inflation can do wonders to diminishing unemployment, they argued. They even gave a name to this view, and called it "the Phillips Curve," which has shaped policies for decades in the U.S. and Western Europe.

More rubbish, said Hayek. Writing voluminously about the short- and long-term dangers of inflation, which he compared to drug addiction, Hayek argued that inflation was Employment's great enemy, that high levels of employment were consistent with low levels of inflation. In this too he has been proved correct.

He also examined the far broader consequences of unexpected inflation policies on political stability, on creating conflicts between property owners, and those living on fixed incomes, on the effects debasing a currency has on contractual agreements, topics that found the narrowly trained and specialized Keynesians completely baffled. It fell to political leaders like Margaret Thatcher, Ronald Reagan with the constant help of part of the press such as The Wall Street Journal and Forbes, to throw the Keynesian theory overboard and set their economies on a healthy course by killing inflation. In fact the role the press plays preventing people to lapse into disciplinary blindness was also among the themes Hayek raised.

Briefly: Hayek showed that to insure prosperity, we must keep the broader picture in mind, and not lapse into trivial technicalities. We must assure that laws allow people to experiment, that these laws do not just define these rights, but there is an independent judiciary and police who enforces them; that information comes from many independent sources, and that the type of restrictions that, for example, Xinhua, China's state-run central agency set on all aspects of Dow Jones' business in the country, can be criticized. Economics cannot be examined in isolation. In contrast, the Keynesians offered a neutrally-sounding theory, with pretensions of science, keeping political institutions out of sight.

And going from the broader to narrower issues, Hayek foresaw the difficulties into which social security would run as it grew from a modest program designed to relive poverty – the necessity of which arrangement Hayek never questioned (though his attackers suggested otherwise) – into a gargantuan income redistribution Ponzi scheme. He foresaw the decline of quality in nationalized health care and education, and the devastating effects of high taxes. Far from preaching anarchism or even radical libertarianism, Hayek thought government had a positive role to play in defense, anti-trust enforcement, limited safety-net programs and the like; he saw nothing wrong with devoting up to 25% of national income to financing government (more during wars and other national emergencies). But he feared the tendency of government to accept no limits, and urged that health, education and other government-provided goods should be privatized wherever possible. One suspects that Hayek would be pleased, but not entirely surprised, to see electricity, telecommunications, transportation, privatized in the years since his death.

As he made clear in his discussions of the importance of spontaneous (as opposed to planned) development, Hayek viewed competition exactly as businessmen have always seen it: a process of experimentation, where ambition, ideas, institutions, capital and luck all interact to produce information. People absorb this information, correct past mistakes, and discover new patterns. Bill Gates misses first the internet. But as information accumulates, his company reacted quickly, and thrived. Steve Jobs created the market for personal computers, but did not realize where the commercial potential was. Apple persisted with its mistakes and fell behind. Although, after a decade, Steve Jobs both revived the company he created, and discovered opportunities in computer animation.

Compare this rich view with textbook microeconomics, where there are no entrepreneurs, no risk-taking, no questions raised on how to finance risk-taking, create liquid markets or build – or fail to build – internal arrangements within firms to prevent lasting mistakes. The notions of people betting on new ideas and the conditions necessary to finance these ideas and bring them to market is absent from neoclassical microeconomic theory. When one compares the sterility of much that passed for "micro-economics," with what one could learn about business and, at the same time, history, law and philosophy by reading Hayek, one may become even more puzzled at his lack of influence.

Yet, there is no smoke without fire, and Hayek's relative obscurity in both universities and public discourse for more than four decades teaches some great lessons. Let's examine them.

Models of Society: First Let's Live, Later We'll Philosophize

How do people know if communism is good, if socialism is better, if corporate capitalism is an improvement and, if entrepreneurial capitalism is the best system of all, allowing people to realize their dreams? Obviously the best test is to let people vote with their feet. There is little doubt then that today people view the US's democracy and its open capital markets as the best system. People form long lines to get in, and if they can't enter legally they try to come in illegally.

But there were times when the US's superiority, and that of less centralized economies, was far from evident. Let's go back in time to the 1920s and 1930s. What did people see then? They saw hyperinflation in Western Europe, and massive unemployment in both Europe and the US. Both led to political changes accompanied by a drastic expansion of government powers, including central planning. This is when Hayek's view started to be overshadowed.

Central planning went by various names – the New Deal in Franklin Roosevelt's US, militarization in Hitler's Germany. In the US, the Civilian Conservation Corps provided jobs for 3 million young, unmarried men in work camps, over 10% of the workforce at the time. Though other agencies in the US offered wages under lesser constraints, they decided on the type of employment. At first glance this does not look significantly different from Soviet-type central planning – Hayek's anathema.

While Hayek and Keynes debated, countries adopted a variety of more centralized approaches to run their economies during these years, from the Soviet extreme, to "strategic" nationalization in Britain, to government-business-labor corporatism in Germany to regulations and New Deals in the United States.

And that is how it typically happens. People want to live first and philosophize later. Hyperinflation wiped out the middle-class savings in many Germany, Austria, and Hungary. Lives were unsettled in the US during the 1930s by 30 percent unemployment and 30 percent deflation, leading to a series of bank failures and bankruptcies. People looked for solutions. Academic debates about causes of crises became marginal. Hayek continued to believe that the crises were symptoms of "business cycles" and that things will improve without intervention by central banks or governments. Keynes argued the opposite.

Why was Keynes' solution right – even if his vision was completely wrong? And why was Hayek's solution – of just waiting patiently – wrong, although his vision of the world was right? Why did "centralization" bring solutions in these circumstances? What did Hayek miss in his analyses?

What Hayek missed, among others, was this. To prosper, people must have access to capital. One can inherit it, accumulate it by saving and most important, raise it in financial markets. However, if savings and inheritance are wiped out, and the banking system fails – and that's what happened in the 1920s and 1930s – there are only two ways remaining to restart the engine, flawed as these ways are. One is to turn to government, which becomes a lender of last resort. The second is "crime" – crime organized by the state in particular.

Here is what this means. There is an old clause in the laws of Ine of Wessex: if fewer than seven men attack private property they are thieves, if between seven and thirty-five, they are a gang, if more than thirty-five, they are a military expedition. Multiply by a few thousands, and a military expedition was the form the German organized crime reaction took in the 1930s. This was a reaction to the sudden wiping out of people's wealth due both to hyperinflation and the burden imposed by the Versailles Treaty. When suddenly seeing their wealth wiped out, and financial markets weakened, some people turned to government and others to organized "crime," covered by new ideological labels.

Hayek (and, by the way, Joseph Schumpeter) failed to see in the 1930s that governments had a critical role to play in restoring financial markets to health. In the depths of the depression, they continued to argue against attempts to expand credit, lower taxes and tariffs. This is curious, because in all of Hayek's work the fact that people make mistakes is central to his analysis. When he discusses "The Monetary Framework" in his Constitution of Liberty, he does say that once there was government interference, some self-regulating mechanisms become "closed," and one must look for some compromised solution. Yet he never asks the question: if grave fiscal, monetary and political mistakes were done, and they are not immediately identified as "mistakes," then just what are people and governments supposed to do? It is not enough to say that "eventually" people will discover institutional solutions to prevent these mistakes from happening. "Eventually" can take a long time.

Unless the government "compensates" one way or another with another intervention, or central banks interfere again to correct their mistakes, the "market" cannot make a correction. How can "the market" correct for grave fiscal and monetary mistakes? Can the market "correct" for a marginal income tax rate of 80% – the rate in effect in the UK for several years before Margaret Thatcher came to power.

Indeed not. What the "market" can do in this case is allow human and financial capital to flow out. And this is what happened in the UK, where a combination of inflation and high taxes led the country down the drain in the 1970s. It was Member of Parliament Keith Joseph, who spoke relentlessly about bringing back entrepreneurship and initiative to the UK, who created a think tank that began spreading the ideas of Hayek and Milton Friedman in Britain. Margaret Thatcher tuned in. Her Hayek-inspired policies in the 1980s have since made Britain the European Union's most dynamic economy by far.

So here we are: in the 1930s, politicians bet on Keynes' views because the country was in a mess, and they did not quite know why. Keynes offered a solution, which happened to be the right one, though he gave the wrong reasons and in a most obscure language. Hayek did not have any solution, and he fell in relative oblivion. Forty years later, the UK is in big trouble, and Margaret Thatcher rediscovers entrepreneurial capitalism in Hayek's writings. Hayek's framework offers now a vision, whereas Keynes' framework offers neither a vision, nor a solution – and he falls into oblivion.

One lesson for countries around the world is clear, and it is consistent with Hayek's broader vision of spontaneous order. Grave political, fiscal and monetary mistakes have been the source of people's troubles around the world, in the 1930s as now. During such troubles they bet on new ideas. We may not always recognize quickly that these have been good or bad ideas. The lesson from the story told above is simple: the best thing we can do is to allow governments to have less scope for error. Or, if they already committed them, have more of those checks and balances in place to correct the mistake more quickly.

One way to do it is to eliminate governments' intervention in "the market of ideas."

Under What Conditions Will the Better Ideas Win Faster?

Today bad ideas can have long lives. It's not true that we have "free speech" today. What we do have is a lot of subsidized speech.

One of the things many governments and heavily subsidized international agencies pursuing disastrous policies have in common is that neither had any difficulty finding pliable "scholars" to decorate their self-serving policies with high-flying jargon. For their services, governments bestowed honors on these "scholars," complete with publicity and an aura of "science." But "science" – social science in particular – becomes mercurial when politicians are expected to use it. It has happened since time immemorial.

When rulers wanted to base their actions on the movement of the stars, they put in place Councils of Astrological Advisers, and many ambitious youngsters became astrologers. Members of such councils made forecasts based on complex, logical calculations (astrology was viewed as science for 150 years) – even if they did not believe a word of what they were predicting. This is what the great 17th century German astronomer, Johannes Kepler, confessed in his diary. Kepler did it because, unlike astronomy, astrology paid.

The German philosopher Friedrich Hegel's lasting reputation has similar sources as Keynes'. His views about the advantages of concentrating power in the hands of the state, and that all learning should be subordinated to state interests, suited his employer, Frederick William III, who installed Hegel as the certified Great Philosopher, though Scientists of his time considered him a charlatan. Nevertheless, once governments subsidize such ideas, mercenary followers will rush to proclaim them to be immortal wisdom and put them and the field of study created on a pedestal.

The long life of astrology, of Hegel's philosophy, of Marxist and Keynesian theories – not to mention a dozen of other lesser known intellectual fads and obscurities filling now both the academia and public discourse – could not have happened without extensive subsidies. Subsidies prolong the lives and influence of the "sciences" of political lies by a mixture of political interest, and of subsidizing both their exposure and transmission through subsidized education to future generations. Of course people will come up with mistaken ideas all the time: that's what science is all about, experimenting with ideas. But the lesser the subsidy, the lesser the persistence in error.

We are not yet there. And neither political classes nor the subsidized universities, nor the subsidized international agencies have incentives to get there quickly. If Margaret Thatcher succeeded to inspire her countrymen with Hayek's entrepreneurial vision, that happened because the UK was broke and was falling further and further behind, and not because the better ideas win. If the rest of the world abandoned the various centralized experiments during the last decade, that too happened because they were broke too, and governments could no longer have the funds to frighten and bribe people into obedience – the Soviet Union being the best example. They did not decentralize because they rediscovered either Adam Smith, Hayek, or Friedman.

For better and for worse, bankruptcy and fear of failures are mothers of innovation, and the political arena is no exception. When such fears rise, people need a new anchor, politicians have to supply one, and they look for ideas, new or shelved. Keynes was a product of the 1930s. Hayek re-emerged when the bankruptcy of Keynesian policies became obvious in the 1970s.

Once governments have smaller roles, or are held more accountable through a greater variety of institutions like well-functioning capital markets, political opposition, the media, separation of powers, enforcement of property rights, their ability to make grave mistakes is also smaller. Bad ideas would have then much shorter lives. That is why I bet, that with the trends emerging today, Hayek’s vision of entrepreneurial capitalism as the basis of success, will reshape public discourse, whereas most of what passes for "economics" today will meet astrology's fate.

Not a moment too soon.