First PRINCIPLES SERIES

No. 36

Ten (Mostly) Hayekian Insights for Trying Economic Times

Bruce Caldwell

Abstract: *The economist Friedrich Hayek attempted in his writings to spotlight the interlocking set of ideas—constructivist rationalism, scientism, socialism, "the engineering mentality"—that was leading the West down what he famously called the road to serfdom and to propose in its place a return to a revitalized form of classical liberalism. In this essay, Professor Bruce Caldwell draws upon the writings of Hayek, other Austrian economists, and public choice theorists to distill 10 fundamental insights that not only apply to the current crisis, but also can help us to think more clearly about the nature and limits of economics more generally. His conclusion: We usually do not have the necessary knowledge to intervene effectively in the economy, and the political process is such that, even if we did, we still likely would get bad policy, coupled with an ever-growing government sector. Hence the preference for smaller government among Austrian economists and public choice theorists.*

I will begin with an observation that is rather commonplace among historians: History provides no magic bullet. What it provides is perspective. It shows what sorts of ideas our predecessors entertained, the sorts of policies that their ideas led them to, and what transpired as a result. It also allows us to see that our times are not unique and that, as bad as things sometimes seem, there have always been worse times. We need only think, for example, of what Friedrich Hayek lived through: two world wars, hyperinflation, the creation of the Soviet Union, the Great Depression, and the birth of the welfare state.

I mention Hayek here, and will draw on his ideas and writings throughout this essay, because I am a Hayek scholar. But to buttress my insights into the economy, many others could as easily have been cited, not only those who participated directly in the Austrian school like Ludwig von Mises or Ludwig Lachmann, or the Austrians who were more on the periphery like Fritz Machlup or Gottfried Haberler, or even non-Austrians like James Buchanan, Ronald Coase, Douglass North, or Vernon Smith. I see such scholars as all contributing to a broad tradition that challenges the authoritative pretensions of economics and offers an alternative view of the way that the world works. They are all, I would submit, advocates of basic economic reasoning, the sound core of ideas that economics contains and which we forget only at our peril.

In what follows, I will identify 10 key themes to be found in the writings of Hayek and others in the

Published by The Heritage Foundation LEADERSHIP FOR AMERICA

214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

tradition to which he belonged that may provide some insights into how we might respond to the current dilemmas that we face. Before I do so, I should briefly introduce Hayek since not everyone is familiar with this remarkable man.[1]

THE LIFE AND TIMES OF FRIEDRICH AUGUST VON HAYEK

Born on May 8, 1899, the polymath economist and social theorist Friedrich August von Hayek had the good fortune to be repeatedly in the right place at the right time, crossing paths with some of the century's most brilliant economists and thinkers. He grew up in Vienna, at the time a place of extraordinary intellectual vitality. After finishing his studies at the University of Vienna, Hayek spent 15 months in the United States where, armed with letters of introduction from Joseph Schumpeter, he encountered most of the major American economists. When he returned, he joined the *Miseskreis*, the study circle of Ludwig von Mises, the leading Austrian economist at the time.

In the later 1920s, he published an article in German that was read by Lionel Robbins, a newly appointed professor at the London School of Economics (LSE). This led to an invitation to present some lectures and ultimately, in 1932, to Hayek's being appointed to the Tooke Chair of Economic Science and Statistics. While at the LSE, Hayek would engage in debates on the leading issues in economics with some of the discipline's most important members, including John Maynard Keynes.

Hayek remained at the LSE until 1950, when he moved to the Committee on Social Thought at the University of Chicago. There he counted among his colleagues Milton Friedman, Aaron Director, and George Stigler. Retiring in 1962, Hayek had successive appointments at the University of Freiburg and the University of Salzburg, returning again to Freiburg in 1977. In 1974, he was awarded, with Gunnar Myrdal, the Bank of Sweden Nobel Prize in Economic Sciences; in 1991, he was awarded the Presidential Medal of Freedom. Hayek died in Freiburg on March 23, 1992.

Hayek attacked socialism when most members of the intelligentsia viewed it as a preferred middle way between an apparently failed capitalist system and totalitarianisms of the communist and fascist varieties; for Hayek, such thinking was "the muddle of the middle."

If Hayek was in the right place at the right time, it was usually with the wrong ideas, at least from the perspective of most of his contemporaries.

- He was a sharp critic of Keynes well before the onset of the Keynesian Revolution. Though he helped to introduce English-speaking economists to general equilibrium theory, he claimed that a preoccupation with static equilibrium analysis would mislead economists about the true nature of a dynamic market process.
- He attacked socialism when most members of the intelligentsia viewed it as a preferred middle way between an apparently failed capitalist system and totalitarianisms of the communist and fascist varieties; for Hayek, such thinking was "the muddle of the middle."
- When most Western democracies were embracing some form of the welfare state, he criticized the concept of social justice that provided its philosophical foundations.
- While most of the social sciences were moving toward more and more specialized studies, his work was increasingly integrative and multidisciplinary.

[1] The following biographical sketch is adapted from Bruce Caldwell, "Hayek, Friedrich August von (1899–1992)," in *The New Palgrave Dictionary of Economics*, 2nd edition, ed. Steven N. Durlauf and Lawrence E. Blume (London: Palgrave Macmillan, 2008).

The views Hayek embraced over most of his career were almost systematically out of step. From the perspective of the early 21st century, however, history would judge Hayek's legacy more kindly than did many of his contemporaries.

- He lived to witness the collapse of the Soviet bloc, which many took as vindication of his and Ludwig von Mises' early critique of central planning.
- His view that a competitive market system with freely adjusting prices is an essential mechanism for coordinating social action in a world of dispersed knowledge is taken by economists as a fundamental insight.
- His insistence that markets be embedded in a host of other social and political institutions for their proper functioning provides a jumping-off point for such diverse movements within economics as experimental investigations of market institutions, public choice and constitutional analysis, and the new institutional economics.
- Philosophers of mind, evolutionary biologists, and neuroscientists have been attracted to his "connectionist" approach for understanding the development and functioning of the brain.
- His theory of complex phenomena and work on spontaneous orders has clear analogues in complexity theory and agent-based computational modeling.

If Hayek remains a controversial figure in some quarters, even his critics acknowledge the breadth and depth of his contributions. One pundit, writing in *The New Yorker* in 2000, even went so far as to call the 20th century "the Hayek century."[2] Considering that this was only about two decades after the British Labour politician Michael Foot had referred to him as a "mad professor," the reputational turnabout has been substantial.

[2] John Cassidy, "The Price Prophet," *The New Yorker*, February 7, 2000, p. 45.

THEME #1: THE BUSINESS CYCLE IS A NECESSARY AND UNAVOIDABLE CONCOMITANT OF A FREE-MARKET MONEY-USING ECONOMY.

It is perhaps an exaggeration, but sometimes it seems as though people today are surprised that business cycles—shifts between periods of economic growth and periods of stagnation or decline—can still happen. Hayek, whose first book was titled *Monetary Theory and the Trade Cycle*, certainly recognized the problem, as did his rival on this issue, John Maynard Keynes.

As introductory economics textbooks remind us, money performs many essential functions, among them to provide a unit of account and a store of value.

Hayek's view that a competitive market system with freely adjusting prices is an essential mechanism for coordinating social action in a world of dispersed knowledge is taken by economists as a fundamental insight.

Its most important function, though, is to facilitate trade, thereby making specialization and the division of labor profitable, and thereby establishing key preconditions for economic growth. Money, then, is essential, but as Hayek argued in his first book,[3] money is also the loose joint in a free-market system—hence my designation "free-market *money-using* economy." It will be intimately involved in crises because changes in the money supply affect credit conditions—that is, interest rates—sometimes adversely.

We need not detain ourselves with a full description of the Austrian theory of the cycle here, other than to note that Hayek's theory offers a pretty good description of at least part of what happened in the latest meltdown, especially in terms of the Federal

[3] F. A. Hayek, *Monetary Theory and the Trade Cycle* (New York: Kelley, 1966 [1933]).

Reserve's interest rate policy and its effects on the housing sector. In Hayek's theory, problems start when the market rate of interest is held too low for too long. This always politically popular policy leads to malinvestment—too many investment projects get started that cannot ultimately be sustained. When people realize what has happened, investment spending collapses and a recession begins. The dangers of a prolonged low-interest-rate regime in distorting how the various factors of production in the economy are allocated—what the Austrians call the structure of production—is something to take away from the theory, especially given the political popularity of such a policy.

A much more controversial aspect of the Austrian theory is the claim that the downturn in a business cycle is painful but necessary medicine for restoring equilibrium to the economic system. To the extent that this explanation is sound, it tells you what not to do in terms of policy: namely, it rejects further lowering of the interest rate (stimulative monetary policy) or any other attempts (for example, deficit spending or stimulative fiscal policy) to stimulate demand. There are two reasons why the Austrians reject stimulative fiscal and monetary policies during an economic downturn.

Hayek's theory offers a pretty good description of at least part of what happened in the latest meltdown, especially in terms of the Federal Reserve's interest rate policy and its effects on the housing sector.

The first is that such measures simply perpetuate the problem. If the problem is that the current structure of production does not accurately reflect the actual demand for goods in the economy, you do not want to undertake a policy that serves to preserve that structure of production. The examples of the automotive and house-building industries during the recent crisis illustrate well Hayek's claim.

- In late December 2008, GMAC, the lending arm of General Motors, was given a $6 billion bailout by the Bush Administration. What did they do with it? Within a day, the radio and television were filled with ads saying that GMAC was now providing zero-interest loans and lowering its minimum required credit scores from 700 to 621 (the "subprime" designation applies to loan applicants with credit scores of 660 and below). So to stimulate the economy and revitalize the automobile industry, a policy was adopted that essentially made it easier for people with bad credit to purchase a car.
- The other example is the $8,000 tax credit offered by the federal government in 2009 for first-time homebuyers. The objective, as far as I can tell, was to reduce the inventory of existing homes. Unfortunately, it led to a mini-boom in the construction of new single-family homes. In other words, this policy further increased the supply of housing at a time when the evident problem was an excess supply of housing.

These are paradigmatic examples of how attempts to further stimulate demand can perpetuate an initial malinvestment. The other reason that the Austrians reject stimulative policy in a downturn is that it raises the threat of inflation or of other ills down the road (see my second point below).

This being said, the reason the Austrian message has been almost wholly ignored in the current debate is that it is very dour. Hayek's recommendation back in the 1930s was for the government to try to provide better information in the upswing about potential dangers while letting the economy readjust when the downturn hit.

It is not clear that providing warnings during a boom ever does anything. Smart investors usually know when a bubble is forming, but they also know that there are great amounts of money to be made, fast, if one can stay in until just before the bubble bursts and then get out (investors who are not as smart see money being made and jump in, usually too late, and fail to jump out). We saw in the 1990s that the lure of a fast buck was not overcome by messages concerning the dangers of what Federal Reserve Board Chairman Alan Greenspan called "irrational exuberance," no matter how trusted (at least back then) the source. But even more fundamentally, the Austrian perspective counsels politicians to do nothing at a time when all their instincts are to show voters that the government is doing something.

Hayek's recommendation back in the 1930s was for the government to try to provide better information in the upswing about potential dangers while letting the economy readjust when the downturn hit.

In later years, Hayek proposed that the Fed be done away with and that the competitive issue of private currency by banks be put in its place. This alternative has been trumpeted by certain present-day Austrian economists, and such ideas need to be more widely disseminated and debated. But for those who do not want to go into the intricacies of alternative monetary regimes, it is simply important to recognize that the Austrian message was not popular in the 1930s, is not popular today, and will never be popular. Rather than argue directly for it, perhaps a better strategy is to warn of the dangers of Keynesian economics.

THEME #2: THE 1970s AND WHY KEYNESIAN ECONOMICS WAS REJECTED

The 1970s experience is what got Hayek writing about macroeconomics again. It provided for him the quintessential example of the dangers of scientism—the idea that the purported methods of the natural sciences are equally applicable to social phenomena.[4] He derided the idea that we can engineer the macroeconomy as engineers design a bridge. And as noted above, it was in response to the inflation of the 1970s that he was led to pen his controversial, if too little appreciated, pamphlet "The Denationalization of Money."

There were good reasons why Keynesianism went into eclipse. Though the theory had entered academia decades earlier, the first real experiment with Keynesian demand management policy was the 1964 Kennedy–Johnson tax cut, and it worked like a charm. Economists began to talk about "fine-tuning" the economy—a wonderful metaphor, conjuring up the images of a skilled technician working on a finely tuned machine and also, perhaps, the "fine-tuning" of FM radio, the latter appealing to the innate good taste of the intelligentsia.

The heyday did not last long. When inflation began to appear in the late 1960s due to LBJ's deficits, a precisely calibrated income tax surcharge designed to tamp down demand was imposed. Yet because it was viewed as temporary, it had no effect, and inflation continued to rise. This was the first signal that the machine metaphor might have been the wrong one.

Things got much worse in the 1970s as inflation turned into stagflation. The main lesson of the 1970s was that once inflation gets started, it is very difficult to get rid of it. To fight it, the government has to tighten up the economy. This in turn induces unemployment, and because the effect on inflation is not immediate, for a time both the unemployment rate and the inflation rate go up together.

This politically disastrous outcome led to all sorts of bizarre policy experiments: wage-price controls under Richard Nixon; "Whip Inflation Now" but-

4 Thus, in the introduction to his Nobel lecture, aptly titled "The Pretence of Knowledge," Hayek says: "[E]conomists are at this moment called upon to say how to extricate the free world from the serious threat of accelerating inflation which, it must be admitted, has been brought about by policies which the majority of economists recommended and even urged governments to pursue. We have indeed at the moment little cause for pride: as a profession we have made a mess of things." Reprinted in F. A. Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), p. 23.

tons under Gerald Ford; and Jimmy Carter's malaise speech. The basic problem was that until Paul Volcker became chairman of the Federal Reserve in 1979, policymakers in the 1970s would start to restimulate the economy before inflation was fully driven out of the system, leading to a stop-go policy that was exacerbated by oil shocks and structural changes in the labor market (the entry of young people and women into the labor force). Stagflation was the end result, and it was not wrung out of the system until Volcker induced a very long and real recession—the worst one since the Great Depression and the one that our current downturn should be compared to.

In short, the worst recession since the Great Depression was (1) consciously policy-induced and (2) made necessary by the failed attempts at activist, discretionary policy aimed at combating the business cycle during the previous decade and a half. It is hard to imagine a more vivid cautionary tale, and it explains why Keynesian demand management policy went so rapidly into eclipse three decades ago.

The 1970s provided for Hayek the quintessential example of the dangers of scientism—the idea that the purported methods of the natural sciences are equally applicable to social phenomena.

Am I forecasting that stagflation will reoccur? No, because the economy is too complex to make any such prediction—another Hayekian insight (see my fifth point below).[5] But it is clear that if one puts record amounts of money into the financial system (as the Fed has done to provide liquidity) while the federal government runs record-breaking deficits which promise to exist far into the future, the chances of any plausible exit strategy working become quite remote. As Clive Crook of the *Financial Times* put it in July 2009, "What the stimulus gives, the debt projections take away."[6]

THEME #3: SOME REGULATION IS NECESSARY…

How can we avoid such problems in the future? The answer that many would give is that we need more regulation. As Mark Calabria of the Cato Institute put it: "the growing narrative in Washington is that a decades-long unraveling of the regulatory system allowed and encouraged Wall Street to excess."[7]

Hayek faced an analogous dilemma in 1930s. Free-market capitalism had apparently collapsed, and the favored solution to the problems of the Depression was again more regulation, which then went under the rubric of "planning." Indeed, his friend Lionel Robbins described planning as "the grand panacea of our age."[8] The problem was, then as now, that the word "planning," like the word "regulation," can mean just about anything.

Hayek's strategy was not to deny the necessity of planning. After all, we all plan. It was rather to show how a certain type of planning—namely, central planning of the economy—if fully implemented, would lead to disastrous economic results and ultimately to restrictions on political and personal freedoms. He made this argument in his 1939 pamphlet "Freedom and the Economic System" and developed it further in his most famous work, *The Road to Serfdom*, published in 1944.

In these works, as well as in other writings, Hayek made it clear that he was not advocating an alternative system of pure laissez-faire. The sort of planning that Hayek favored was a general system of rules, one that

5 That there is a tension between Hayek's early step-by-step account of the unfolding of a typical business cycle and his later work on complex phenomena should be evident. I prefer his later work.

6 Clive Crook, "A Rocky Road for the Fiscal Stimulus," *Financial Times*, July 19, 2009.

7 Mark A. Calabria, "Did Deregulation Cause the Financial Crisis?" *Cato Policy Report*, July/August 2009, pp. 1, 6–8.

8 Lionel Robbins, *Economic Planning and Economic Order* (London: Macmillan, 1937), p. 3.

would best enable individuals to carry out their own plans. As he wrote:

> We can "plan" a system of general rules, equally applicable to all people and intended to be permanent (even if subject to revision with the growth of knowledge), which provides an institutional framework within which the decisions as to what to do and how to earn a living are left up to the individuals. In other words, we can plan a system in which individual initiative is given the widest possible scope and the best opportunity to bring about effective coordination of individual effort.[9]

Hayek is talking here, as was his wont, at a very general level. In *The Constitution of Liberty* and other writings, he would provide a little more detail, laying out the set of social institutions that he thought would best enable individuals to utilize their own knowledge to carry out their own plans. These institutions included a market system, in a democratic polity, with a system of well-defined, enforced, and exchangeable property rights, protected by a strong constitution, and operating under the rule of law, in which laws are stable, predictable, and equally applied. Hayek's goal was to enunciate a framework for the creation of a new form of liberalism appropriate for the 20th century and beyond.

But what he came up with was still very general.[10]

Hayek believed that central planning of the economy, if fully implemented, would lead to disastrous economic results and ultimately to restrictions on political and personal freedoms.

Even so, Hayek's contribution here was to stress the importance of the institutional setting, and in that regard he was way ahead of his time. For markets to work effectively, they must be embedded in a set of complementary social institutions. The new institutional economics associated with the work of Douglass North, Ronald Coase, and Oliver Williamson, as well as the experimental work of Vernon Smith, all take off from this basic insight.

Those institutions seem well secured in most of the developed world, but it is also true that they can be brought to ruin virtually overnight by a dictator. The experience of Zimbabwe under Robert Mugabe should be carefully examined by every student of development on the planet. It is a case study in how to dismantle a society, and each step that was taken there can be well described as a negation of one of the principles articulated in Hayek's general vision for a liberal society.

THEME #4: …BUT A LOT OF REGULATION IS FRAUGHT WITH PROBLEMS AND WILL MAKE MATTERS WORSE.

Hayek was less diffident when it came to pointing out the problems with socialist planning, and many of his warnings are applicable, with very little tweaking, to our current situation.

Hayek thought that a planned system with prices set by the government would always be playing catch-up with the rapid price adjustments that occur in a free-market system. In a like manner, regulation

9 F. A. Hayek, "Freedom and the Economic System," [1939], reprinted in *Socialism and War: Essays, Documents, Reviews*, ed. Bruce Caldwell, Vol. 10 of *The Collected Works of F. A. Hayek* (Chicago: University of Chicago Press, 1997), p. 194.

10 One is entitled to ask why Hayek was so loath to fill in the details. My conjecture is that his decision was strategic: He was trying to keep a liberal coalition intact during the years in the wilderness. The various liberals who attended the Mont Pelerin Society ranged all over the map in terms of the sorts of institutions they thought would be acceptable. On the matter of anti-trust, for example, members varied from strict laissez faire to use of anti-trust statutes to ordoliberalism to certain variants of social market economy under which the planning of the competitive environment became very intrusive indeed. Had Hayek provided too many details, he would perforce have been taking sides.

and legislation cannot keep up with market innovation. New sets of regulations and laws always target problems that arose in the *last* crisis. This does little to address the problems of the next crisis, and indeed the new regulations and laws sometimes make things worse. The basic Austrian insight here is that entrepreneurs (including those who realize there is money to be made from devising ways of getting around regulations) are always forward-looking, while regulators and legislators are almost of necessity backward-looking.

As Hayek put it, "the more the state 'plans,' the more difficult planning becomes for the individual."

Regulation also inserts uncertainty. As Hayek put it, "the more the state 'plans,' the more difficult planning becomes for the individual."[11] There was plentiful evidence of this in the recent downturn. In the fall of 2008, each announcement by the Fed and the Department of the Treasury, while meant to reassure the markets, produced more and more panic. It also froze people into inaction. One could imagine the decision-making process that took place in many people's minds: "Should I hold onto my house that is underwater, in the hopes of a government bailout? Should I buy a car now that the prices are low or wait for some government program that will cause them to fall even lower? A stimulus plan is coming, and I don't know what it will look like; probably best to delay all decision-making for now, to wait and see."

Over and over again, we encounter examples of people basing their decisions on trying to guess what the government is going to do. Contrast this with what happens in well-functioning markets, where people make their decisions principally by looking at changes in market prices, prices that reflect underlying scarcities.

A third problem is the tendency for even the most well-intentioned attempts at regulation to be hijacked by strong special interests that are able to bend the regulations or the laws to meet their needs. The examples of this are so everywhere evident—think of the explosion in the use of earmarks or the subsidization of ethanol—that further comment seems unnecessary.

Certain types of legislation, often justified as helping those in need, simply encourage bad behavior, causing increased moral hazard and misaligned incentives. Bailing out those who took large risks—be they homeowners, firms, or bankers—is the standard recent example, as is the "too big to fail" philosophy more generally. About the latter, Hayek, writing in 1978, had this to say:

> We must finally mention another instance in which it is undeniable that the mere fact of bigness creates a highly undesirable position: namely where, because of the consequences of what happens to a big enterprise, government cannot afford to let such an enterprise fail.[12]

He goes on to recommend that the best policy would be to deprive government of the power to provide such protection. At the time, he doubtless had in mind the federal government's bailout of Chrysler. It is a sad irony, but perhaps predictable, that the very same arguments about being too big to fail were being made about the very same American industry some 30 years later.

Another problem with regulation is: Who is to watch the regulators? The most notorious example here is probably still the inglorious episode of the Keating Five in 1989. The Austrians would note that

[11] F. A. Hayek, *The Road to Serfdom: Texts and Documents* [1944], Bruce Caldwell, ed., vol. 2 of *The Collected Works of F. A. Hayek* (Chicago: University of Chicago Press, 2007), p. 114.

[12] F. A. Hayek, "The Denationalization of Money" [1978], reprinted in *Good Money, Part II: The Standard*, ed. Stephen Kresge, Vol. 6 of *The Collected Works of F. A. Hayek* (Chicago: University of Chicago Press, 1999), p. 82.

the market provides its own very effective regulators that go by the names of profit and loss.

Finally, and most basically, the desire to plan endangers liberty. Hayek argued passionately in the 1930s and 1940s that the nation's uncritical enthusiasm for planning put at risk not only the successful operation of a market economy, but democracy and freedom as well. It is no less true today. He found it appropriate then to quote Benjamin Franklin, who said, "Those who would give up essential liberty to purchase a little temporary safety deserve neither liberty nor safety."[13] (And are likely to get neither, we might add.)

Hayek argued passionately in the 1930s and 1940s that the nation's uncritical enthusiasm for planning put at risk not only the successful operation of a market economy, but democracy and freedom as well. It is no less true today.

Hayek knew well that the urge to plan is always with us. He attributed this in his early work to the hubris of reason and traced its origins to the planning mentality and the scientistic pretensions of his age.[14] But as he pointed out in his 1933 address, in the past, the power of markets to organize human activity was revealed most dramatically when we witnessed the ill effects of attempts to regulate them.[15] This has been the experience of centuries and is another reason why the study of history is an essential component of a proper education.

THEME #5: THE ECONOMY IS AN ESSENTIALLY COMPLEX PHENOMENON FOR WHICH PRECISE FORECASTING—ON WHICH THE CONSTRUCTION OF RATIONAL POLICY DEPENDS—IS RULED OUT.

Earlier, I refrained from forecasting the likely outcome of the injection of unprecedented amounts of money into the financial system together with a massive fiscal stimulus program. I did so because we simply do not know what will happen. In fact, it is hard enough even to assess past events. After the stimulus package passed and started to operate, the unemployment rate rose faster than had been predicted and indeed exceeded forecasts of what it would have been *absent* the stimulus (so much for forecasts). Paul Krugman's response to this was that we needed a larger stimulus package. The response of most Republicans was that the rise in unemployment showed that a stimulus program that depends a lot on increased spending simply doesn't work, and they recommended in its place tax cuts, arguing that they would work more quickly. Larry Summers, playing the role of the baby bear, said that the stimulus was just right.

The point is: No one really knows. Each position is consistent with the evidence, and other reasonable explanations are indeed possible. For example, another plausible scenario is that the announcements that were made in fall 2008 concerning the dire condition of the economy—announcements aimed at getting a robust stimulus program passed—in fact caused the ensuing recession to be much worse than it would have been. The point is that we just can't know.

This knowledge problem is a huge obstacle to rational policymaking. When it is joined with other political and economic obstacles, the hope of getting rational policy out of Washington becomes very dim. We know, for example, that there is a lag between the time a problem in the economy is recognized and a policy response is developed, and another between the introduction of

[13] Hayek, *The Road to Serfdom*, p. 156.

[14] In later works like *The Fatal Conceit: The Errors of Socialism*, ed. W. W. Bartley (Chicago: University of Chicago Press, 1988), Hayek attributed our resistance to markets to the fact that a market society satisfies neither our reason (we always think we can improve on market outcomes) nor our instinct (our hunter-gatherer heritage led to certain moral positions—distrust strangers, deal only with parties you know in face-to-face situations—that do not fit in well with market interactions).

[15] F. A. Hayek, "The Trend of Economic Thinking" [1933], reprinted in *The Trend of Economic Thinking: Essays on Political Economists and Economic History*, ed. W. W. Bartley III and Stephen Kresge, Vol. 3 of *The Collected Works of F. A. Hayek* (Chicago: University of Chicago Press, 1991), pp. 17–34.

a policy and its actually taking effect. We have plentiful evidence that the political process sometimes subordinates the stabilization goal to other government policy goals or simply to the self-interested goals of Congressmen and Senators. We know that tax cuts, despite Republican rhetoric, sometimes get saved rather than spent and therefore have little stimulative impact. We know that lower interest rates will not accomplish much if banks are fearful of lending or firms are fearful of borrowing. As it used to be put, you can't push on a string. In sum, the things that we actually do know all concern limitations on our knowledge and on our ability to formulate and carry out rational policy.

When the knowledge problem is joined with other political and economic obstacles, the hope of getting rational policy out of Washington becomes very dim.

It is important to be clear: This does not mean that policymakers cannot get things right when it comes to managing the economy as a whole. It is just that sometimes stabilization policy stabilizes the economy, and sometimes it destabilizes it, and we usually can't tell in advance—and sometimes not even in retrospect—which scenario is unfolding or has unfolded.

THEME #6: IN ANY COMPLEX SOCIAL ORDER, ANY ACTION MAY HAVE BOTH GOOD AND BAD UNINTENDED CONSEQUENCES.

Hayek talked a lot about the unintended consequences of intentional human action. Following Carl Menger, the founder of the Austrian School, he pointed out that many beneficial social institutions have emerged gradually and spontaneously throughout human history. No one, for example, *invented* language, perhaps the most useful and universal of human institutions, and indeed conscious attempts to construct a non-natural language—think of Esperanto—have been miserable failures. Other such institutions include money, the division of labor, trade, and the moral traditions that support a market system.

These institutions have created social cooperation on a global scale, leading to enormous increases in material wealth, even though that outcome was not the intent of any individual participant. Indeed, each individual participant has only a tiny bit of knowledge that he brings to the whole process. I know how to wait tables, you know how to raise chick peas, someone else is a skilled worker in a linen factory; and from these people's efforts and those of hundreds of thousands of others, every day, Paris gets fed, though it was no one's plan, goal, intention, or desire to feed Paris. From Frédéric Bastiat to Leonard Read, many have marveled at this unintended miracle. Hayek often used the word "marvel" to describe the workings of the market mechanism.[16]

The bad side of unintended consequences is that many attempts to impose our will on the complex adaptive system that is the economy cause things to happen that were not part of our original intention. For example, as everyone recognizes, a market system does not satisfy our longings for "social justice."[17] In response, well-intentioned people—or those with interests who can play on the sentiments of the well-intentioned—naturally seek to make adjustments in a market system so as to produce more desirable results. Unfortunately, time and again, history has demonstrated that when aiming at certain ends, particularly when their achievement involves interfering with the

[16] F. A. Hayek, "The Use of Knowledge in Society" [1945], reprinted in *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), p. 87: "I have deliberately used the word 'marvel' to shock the reader out of the complacency with which we often take the working of this mechanism for granted. I am convinced that if it were the result of deliberate human design, and if the people guided by the price changes understood that their decisions have significance far beyond their immediate aim, this mechanism would have been acclaimed as one of the greatest triumphs of the human mind."

[17] Hayek discusses the problems associated with the concept of social justice most extensively in *The Mirage of Social Justice*, Vol. 3 of *Law, Legislation and Liberty* (Chicago: University of Chicago Press, 1976).

Time and again, history has demonstrated that when aiming at certain ends, particularly when their achievement involves interfering with the workings of the price mechanism, all sorts of pernicious effects will occur that were not part of the original intention.

workings of the price mechanism, all sorts of pernicious effects will occur that were not part of the original intention. Some of these patterns are so well established that they have worked their way into our basic economic reasoning.

Hayek was not opposed to experimentation and change, which indeed is one of the driving forces in both the competitive market process and cultural evolution. He thought, though, that piecemeal change is always preferable to wholesale attempts to remake society anew, quoting to make his point Adam Smith's wonderful lines from *The Theory of Moral Sentiments* on the dangers of "the man of system":

> The man of system…seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chessboard. He does not consider that the pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chessboard of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it.[18]

When the man of system is also a man of genius, someone popular and well-trusted by the public who "declaims and insists, not only that the special improvement is a good thing in itself, but the best of all things, and the root of all other good things," the situation becomes especially dire.[19] One suspects that Hayek would not have been sanguine about the recent campaign slogan "Change we can believe in."

THEME #7: BASIC ECONOMIC REASONING CAPTURES WHAT WE CAN KNOW AND SAY ABOUT THE ESSENTIALLY COMPLEX PHENOMENON THAT WE CALL THE ECONOMY.

Hayek argued that, when dealing with spontaneous orders or other complex adaptive systems, often the best that we can do is to make pattern predictions or to offer explanations of the principle by which a phenomenon may work. His examples were usually drawn from areas other than economics. Thus, he explained that we all can understand the principle by which footpaths are formed even if we never observed one being created. He noted that the theory of evolution allows us to understand how speciation works and to rule out certain evolutionary changes, but it does not allow us to predict specific changes that will occur.

What might constitute equivalent sorts of explanations or predictions in the domain of economics?

In my view, the basic sorts of insights about the workings of a market order that economists teach in their introductory classes are what Hayek was talking about when he discussed "explanations of the principle" and "pattern predictions." These insights have evolved slowly, emerging in the writings of the great economists of the past three centuries or so, and are now captured in such everyday classroom constructions as supply and demand curves and production possibility frontiers. These tools allow us to talk about the fundamental fact of scarcity, the choices that scarcity makes necessary, the costs of choice, and the ways to push back against scarcity, at which point the

[18] Adam Smith, quoted in Hayek, *Rules and Order*, Vol. 1 of *Law, Legislation and Liberty* (Chicago: University of Chicago Press, 1973), p. 35.

[19] Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), p. 190. Hayek was quoting Walter Bagehot on the "man of genius" and was using it to deride Franklin Delano Roosevelt's attempt to pack the Supreme Court.

notions of the division of labor, specialization, comparative advantage, the productivity of capital, and the gains from trade are introduced. If one adds to these the concepts of elasticity of demand and supply, and some basic intuitions about market structures, one can explain a lot about the world, as anyone who has ever taught an introductory economics course knows.

It is ironic that in a field in which forecasting is so difficult, the one area where it is relatively easy to predict results is when some form of price-fixing is involved.

I say "basic intuitions" to emphasize that this does not have to be complicated; there is a reason why the introductory course is often labeled "Principles of Economics." This course, if well taught, is probably the most important course that anyone who wants to understand how a market system works can take. It shows how markets work and also how they sometimes fail to work. It also helps one to identify which policy problems are real ones and which are pseudo-problems. For those, for example, who are worried about the world running out of a natural resource like oil, it shows how very effectively the unhindered market deals with such shortages (the price of oil rises, which encourages conservation on the demand side and makes profitable the search for new supplies of oil, as well as for substitutes, on the supply side).

Many of the most compelling examples in a principles class, however, have to do with bad policy responses, and most of these involve some form of price-fixing. Case studies that look at the effects of minimum wage laws, agricultural price supports, rent controls, comparable worth policies, price ceilings on gasoline or natural gas, or laws prohibiting the resale of concert tickets all drive home the very predictable adverse effects of these policies. It is ironic that in a field in which forecasting is so difficult, the one area where it is relatively easy to predict results is when some form of price-fixing is involved. Indeed, in the case of price ceilings, the effects are so predictable that economists have come up with generic categories—the emergence of black markets, deterioration in product quality, and emergence of non-price mechanisms for allocation of the good—to describe the effects of the intervention.

A good economics course will help to identify more appropriate policy responses—responses that utilize markets rather than fixing prices or trying to legislate specific outcomes. The entire field of "free market environmentalism," with its emphasis on the establishment of property rights and the design of institutions that make the best use of market mechanisms, is a case in point.

Last but not least, a good principles of economics class can serve as a counterweight to some of the widely held myths that pass as facts within the popular culture. Take the critique of "neoliberalism," as recently articulated by Naomi Klein in her book *The Shock Doctrine*.[20] According to Klein, neoliberals embrace the shock doctrine: the idea that multinational corporations should enlist the power of national states during times of crisis (sometimes crises that they are complicit in fomenting) to impose a worldwide regime of free trade, thereby ensuring a steady supply of resources from less developed countries, a steady market for their goods worldwide, and a steady flow of profits to their owners.

I would encourage anyone to read Klein's book. Half of it could have been written by Murray Rothbard: I refer here to the places where she talks about the dangers to our liberties and economic freedoms when big states and big corporations collude, or where she documents, in sickening detail, case after case of states trampling on the civil liberties of their citizens, from Chile and Argentina to Russia and China. A good libertarian could take the facts documented in the book and construct a devastating case about the dangers of untrammeled state power.

Unfortunately, Klein was raised by socialist parents in Canada and apparently never had an econom-

[20] Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism* (New York: Henry Holt, 2007).

ics course. She makes the fantastical accusation that economists from the University of Chicago, and in particular Milton Friedman, developed the doctrine to support the power of corporations and their owners. She is exactly wrong, of course, about Friedman's position. He supported free trade for a number of reasons, but a principal one was that it serves to *limit* the power of corporations.

Rather than an extended argument, I will only offer here an anecdote to illuminate Friedman's position. When I was in graduate school, I was fascinated with what happens when a few players dominate an industry. Markets work well when they are competitive, but what happens when an industry, like the U.S. automobile industry at the time—this was before the oil embargo and the subsequent increase in the price of gasoline brought the American automobile industry to its knees and to Washington to beg for protection—grows too powerful? How could such powerful firms be constrained?

I got my answer one day when Milton Friedman came to speak at a nearby university. I chanced to run into him as he was leaving the auditorium after his talk, so I asked him his opinion on the matter. He turned to me, put his hand on my shoulder, and asked: "Given your knowledge of economics, what one policy could we implement that would limit the power of the automobile industry?" "Open up our markets to foreign competition?" I ventured. He smiled, patted me on the shoulder as if to say, "Good boy," and went on his way.

Sadly, this basic insight, that international trade is a way of constraining the power of large domestic firms, has little traction among the oceans of protesters who show up at every trade meeting. They do not realize that the policies they favor would, by granting them protection from foreign competition, make American corporations more powerful.

THEME #8: THE CRY FOR SOCIAL JUSTICE IS BOTH MISGUIDED AND DANGEROUS.

As noted above, Hayek recognized that a market system necessarily results in an unequal distribution of income. Many critics of markets cite disparities in income as *prima facie* evidence of a lack of fairness. Of course, the causes of income inequality are many and are rooted in differences in everything from initial endowments to effort to intelligence to luck. We usually do not think it unfair when someone who works hard succeeds, and only the most curmudgeonly among us would begrudge someone who has experienced a run of good luck, if only because we all wish it for ourselves.

Hayek viewed the cry for social justice as both misguided and dangerous. His first claim was that it was wrong even to apply the concept of "justice" to something like an impersonal market process.

Still, the wide disparities in income that a market system inevitably fuels call for reform, for the imposition of some sort of egalitarian "social justice." How might one respond? Must those who favor markets argue for social *injustice*?

Hayek viewed the cry for social justice as both misguided and dangerous and offered a number of arguments against it. His first claim was that it was wrong even to apply the concept of "justice" to something like an impersonal market process. For Hayek, justice is an attribute of human conduct. As such, a person's or an organization's actions may be deemed just or unjust. The market process generates a specific income distribution, but since that distribution was not the result of anyone's design, it is wrong to speak of it as just or unjust, just as it would be wrong to speak of, say, a misfortune like contracting a disease or losing a loved one as just or unjust.[21]

A second argument invokes the rule of law, the notion that all people should be treated equally under the law. If we accept this principle, equal treatment of

[21] F. A. Hayek, *The Mirage of Social Justice*, Vol. 2 of *Law, Legislation and Liberty* (Chicago: University of Chicago Press, 1976), pp. 31–33.

all, and then add the observation that people differ in their attributes, we are led naturally to the result that different people will experience different outcomes. Conversely, the only way to get similar outcomes for different people is to treat them differently. Egalitarianism of this sort goes against the rule of law and, more generally, against the idea that if we set up a game in which the procedural rules are viewed as fair, a particular outcome might be viewed as unfortunate, but it cannot rightly be judged to be unfair.[22]

By the 1970s, Hayek worried about coalitions of organized interests, and often well-off special interests, that would use pleas for greater social justice to advance their own ends.

A third argument is that even if we were to accept the general desirability of some form of redistribution of income, the principles by which it might be made to work are unclear and often presume that we possess knowledge that we can never in fact possess. Take, for example, the notion that we should reward people according to "merit." Hayek points out that merit typically is "not a matter of the objective outcome but of subjective effort. The attempt to achieve a valuable result may be highly meritorious but a complete failure, and full success may be entirely the result of accident and thus without merit."[23] Thus, if we set up a merit system in which we rewarded people according to their efforts, regardless of outcome, those who were least skilled and therefore had to try the hardest would be rewarded the most, and those who achieved much by little effort, the least. If one is concerned with the total amount of goods produced, such a system is as perverse as one can imagine.[24] But leaving that aside, since merit is a matter of subjective effort, we could never have the knowledge necessary to determine which acts are in fact meritorious.

Somewhat controversially in the eyes of certain Austrians and libertarians, Hayek argued that in a society that had reached the general level of wealth that Britain or the U.S. had achieved, "there can be no doubt that some minimum of food, shelter, and clothing, sufficient to preserve health and the capacity to work, can be assured to everybody" and also that the state should "assist the individuals in providing for those common hazards of life against which, because of their uncertainty, few individuals can make adequate provision."[25] He was, in short, in favor of some form of safety net, at least in 1944. By the 1970s, however, he worried about coalitions of organized interests, and often well-off special interests, that would use pleas for greater social justice to advance their own ends.

Wherever one might come down on the desirability of a safety net, perhaps the strongest argument for a market system is that it has led to a better standard of living for literally billions of people worldwide. The point has been well made by Peter Saunders in his memorable piece "Why Capitalism Is Good for the Soul":

> The way this [capitalism] has enhanced people's capacity to lead a good life can be seen in the spectacular reduction in levels of global poverty, brought about by the spread of capitalism on a

[22] Hayek, *The Constitution of Liberty*, p. 87: "From the fact that people are very different it follows that, if we treat them equally, the result must be inequality in their actual position, and that the only way to place them in an equal position would be to treat them differently. Equality before the law and material equality are therefore not only different but are in conflict with each other; and we can achieve either the one or the other, but not both at the same time." Not all market critics would accept, of course, that the "game" is fair.

[23] *Ibid*., p. 95.

[24] In describing how a market system allocates rewards, Hayek notes: "The long and the short of it all is that men can be allowed to decide what work to do only if the remuneration they can expect to get for it corresponds to the value their services have to those of their fellows who receive them; and that *these values which their services will have to their fellows will often have no relations to their individual merits or needs*." Hayek, *The Mirage of Social Justice*, p. 72.

[25] Hayek, *The Road to Serfdom*, p. 148.

> world scale. In 1820, 85% of the world's population lived on today's equivalent of less than a dollar per day. By 1950, this proportion had fallen to 50%. Today it is down to 20%.... In 1900, the average life expectancy in the "less developed countries" was just thirty years. By 1960, this had risen to forty-six years. By 1998, it was 65 years. To put this extraordinary achievement into perspective, the average life expectancy in the poorest countries at the end of the twentieth century was fifteen years longer than the average life expectancy in the richest country in the world—Britain—at the start of the century.[26]

From this perspective, the extension of free markets, while leading to income inequality, simultaneously increases the total size of the pie to be shared and thereby benefits mankind as a whole. There are many ways to think about "social justice." Advocates of markets would do well to emphasize benefits that extend to the world as a whole.

THEME #9: THE BASIC HAYEKIAN INSIGHT—FREELY ADJUSTING MARKET PRICES HELP SOLVE THE KNOWLEDGE PROBLEM AND ALLOW SOCIAL COORDINATION.

How has capitalism been able to accomplish so much in such a short time? For Hayek, the answer was that markets allow for the coordination of individual plans on a vast scale. Markets, in short, help to solve "the knowledge problem."

Hayek's best articulation of the process is contained in his classic 1945 essay "The Use of Knowledge in Society." He begins there by asking a very simple question: What problem must we solve if we want to construct a rational economic order? He points out that *if* (and he italicizes the *if*) we had all the relevant information about preferences, endowments, and technology, the problem would solve itself, as it would simply be a question of logic. In such a world, we could put everything into the hands of a central planner, who would then allocate resources and goods to their highest valued uses.

A market system with freely adjusting market-determined prices is, when embedded within an appropriate institutional structure, a marvelous mechanism for coordinating human action.

All of the *problems* for constructing a rational economic order arise precisely because we do not have such information. Instead, in the real world, knowledge is dispersed among millions of people. Each person has a bit of localized knowledge, or what Hayek calls "knowledge of the particular circumstances of time and place."[27] In the real world, it is also the case that some people are mistaken about what they think they know. The question that must be solved in constructing a rational economic order in such a world is: How can we use the knowledge that is dispersed among millions of fallible market agents so as to achieve some level of social coordination and cooperation?

Hayek's answer was that a market system with freely adjusting market-determined prices is, when embedded within an appropriate institutional structure, a marvelous mechanism for coordinating human action. As noted above, a free-market economy is a complex system. It is also an *adaptive* complex system, which helps to explain why it works. As Hayek illustrates with his famous tin example, whenever a change occurs somewhere in the system, price adjustments immediately signal millions of market participants that something has changed, and this causes some of them (those on the margin) to adjust their behavior, which of course sends further signals out into the

---

[26] Peter Saunders, "Why Capitalism Is Good for the Soul," *The Insider*, Spring 2008, p. 17.

[27] Hayek, "The Use of Knowledge in Society," *Individualism and Economic Order*, p. 80.

system, causing further adjustments, *ad infinitum*.[28] As Hayek put it, "The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all."[29]

Hayek admitted that* if *we had more knowledge we could do a lot more to improve the world. But we don't, and much of the knowledge we actually do possess is due to the workings of the market mechanism.

In a world that is filled with unpredictability, where "the man on the spot" has only his own small bit of local (and sometimes tacit) knowledge, market signals provide information on which he can base his decisions. His decisions, together with those of millions of others, feed into the system to form the prices that emerge. The actions of market participants are thereby simultaneously price-determined and price-determining. Bad decisions and mistakes are constantly made, but in a market system, errors made by some are opportunities for others, and the latter's profit-seeking actions help to correct them. The self-regulating market system, when it is functioning well, reduces some of the unpredictability that we all face in the economic arena and helps to coordinate our actions with those of millions of others. It also allows individuals to act on their own local knowledge and thereby allows others to make use of that knowledge even though they do not posses the knowledge themselves.

The flip side of Hayek's insights provides a warning to those who seek to improve on markets. Two sorts of errors are possible. The first is not to recognize that for the vast coordination mechanism to work, agents must be allowed to act on their knowledge, and prices must be allowed to adjust freely. Many "reforms," of course, do just the opposite, seeking to restrict entry into markets or to keep prices from adjusting on the grounds of protecting the consumer, assuring the quality of a product or service, supporting diversity or equity or balance or fairness, and so on. The second error lies in assuming that decision-makers have more knowledge than they in fact have. Hayek admitted that *if* we had more knowledge we could do a lot more to improve the world. But we don't, and in the world we live in—a world of dispersed knowledge—much of the knowledge we actually do possess is due to the workings of the market mechanism.

THEME #10: THE BASIC PUBLIC CHOICE INSIGHT—MORE OFTEN THAN NOT, GOVERNMENT CURES ARE NOT ONLY WORSE THAN THE DISEASE, BUT LEAD TO FURTHER DISEASE.

Although some have occasionally identified public choice insights in the writings of Hayek and other Austrians, I think that it is fair to say that the public choice school is a separate though complementary intellectual development. Just how complementary it is will be evident once the following list of public choice insights has been outlined.

A central claim concerns "the rationally ignorant voter," by which I mean the voter who deems it to be in his interest not to stay informed. Since learning the various candidates' positions on a host of issues is costly and the chances of an election turning on a single voter's ballot are miniscule, many voters rationally choose not to be very informed about the issues. When one couples this with Bryan Caplan's argument that public opinion generally favors policies that not only make voters feel good or moral or more American (for example, raising the minimum wage to fight poverty or attributing a rise in gasoline prices to the greed of

[28] The ongoing nature of this process is why Austrian economists usually use terms like "market process" or "evolving market order" rather than "market equilibrium" when speaking about how markets function. The last can lead one to the false image of a system making a final adjustment to a state of rest.

[29] Hayek, "The Use of Knowledge in Society," *Individualism and Economic Order*, p. 86.

oil corporations), but also make for policy outcomes that most economists and more educated voters view as pernicious (for example, increasing the incidence of unemployment among the least skilled workers or passing "excess profit tax" legislation that reduces the supply of domestically produced oil),[30] it is hard to feel much confidence in the policy that is generated in a democracy. From this perspective, politicians who seek to be re-elected are justified in supplying voters with the policies they want even though they are unsound.

A second claim has to do with the effects of concentrated benefits and diffused costs on policymaking. Politicians frequently pay lip service to "the public good," but if a politician is to be successful (that is, stay in office), he or she will typically support policy that is aimed at benefiting the well-organized and informed few rather than the unorganized and uninformed many. As a result, legislation tends to favor special interests over the public good, and once a policy is in place, it is nearly impossible to get rid of it.

Public choice theorists believe that politicians, like everyone else, act in their own self-interest. If consumers maximize utility, firms maximize profits, and politicians maximize votes, what do bureaucrats maximize? The answer is troubling: Bureaucrats have an incentive to maximize the size of the bureaucracy under their control. Governments don't shrink; they grow. Never has the triumph of hope over reality been better illustrated than by the steady stream of politicians who promise to pay for new programs by "reducing waste and inefficiency" in the existing government.

In their wonderfully titled 1977 book *Democracy in Deficit*,[31] James Buchanan and Richard Wagner made the point that democratic politics leads naturally to deficits. Politicians typically insist that they intend to constrain the growth of government spending, but in reality they seldom are able to overcome (and, given the ignorance of the electorate, seldom need to do so) the natural incentives of increasing government spending and decreasing taxes. Can anyone remember a politician who campaigned successfully with a platform of *raising taxes*?

If a politician is to stay in office, he or she will typically support policy that is aimed at benefiting the well-organized and informed few rather than the unorganized and uninformed many.

The past 30 years have demonstrated this to be one of the few areas in which bipartisan endorsement of a basic principle has been nearly complete. For a case study of how difficult it is for politicians to actually cut government spending, even when they have a mandate to do so, one need only consult William Greider's classic 1981 piece "The Education of David Stockman."[32] While constantly mouthing the rhetoric of balanced budgets, Ronald Reagan offered up instead tax cuts and substantially smaller cuts in government spending and won two terms.

When George H. W. Bush tried to balance the budget by raising taxes, he was excoriated by his own party and served only one term. After that, the policy of cutting taxes but leaving government spending intact became canonized in certain Republican circles under the cynical "starve the beast" philosophy. For a while, it seemed as if the only difference between the two major American parties was that the Democrats favored tax and spend, while the Republicans favored *don't* tax and spend. This changed in 2008, when the Democrats began following the Republican mantra

[30] See Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, N.J.: Princeton University Press, 2007).

[31] James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

[32] William Greider, "The Education of David Stockman," *The Atlantic*, December 1981, pp. 28–54.

in spades. It seems that no one these days, with the exception of Libertarians and Ron Paul, speaks about a smaller government, period.

Another central concept in the public choice literature is the notion of rent-seeking. Firms can compete successfully in two ways: directly, by producing a better product at a lower cost than their rivals, or indirectly, by getting the government to grant them an advantage over their rivals through the granting of subsidies or the imposition of licensing restrictions, taxes, tariffs, or quotas on their competitors. Given an expected level of added profits from getting the government to intervene, a firm would be justified in spending up to that amount in lobbying the government to do so. Such rent-seeking behavior is a waste of resources but takes place all the time. Gordon Tullock once asked: "[W]hy is the level of rent-seeking as small as it is?" Perhaps it is time for him to recalculate his estimates.

The best regulator for market behavior is the carrot of profits and the stick of losses. No equivalent regulator exists when the government undertakes a project.

We said above that the best regulator for market behavior is the carrot of profits and the stick of losses. No equivalent regulator exists when the government undertakes a project. Indeed, if a government program does not achieve its goals, the solution always seems to be: We just need to spend more money.

Finally, it is evident that many government programs introduce moral hazard into the marketplace, undermining initiative and the taking of responsibility for actions. From welfare programs for the poor to welfare programs for the rich (the socialization of losses under the bailout programs being the most recent example of the latter), ubiquitous government intervention makes all of us more likely to seek a handout.

The list of ills that public choice theorists have identified leads one to a general three-step principle that, if followed, can help to minimize the impact of government intervention.[33] In capsule form:

- Negotiation (as occurs in market exchange) is always preferable to adjudication.
- If negotiation fails, adjudication that clarifies rights is always preferable to regulation or legislation.
- Only if both negotiation and adjudication fail should one turn to regulation or legislation.

Unfortunately, too often, regulation and legislation are the first and only step.

In conclusion, if we combine the last two insights, we see that the Austrian economists and the public choice theorists deliver a one-two punch: We usually do not have the necessary knowledge to intervene effectively in the economy, and the political process is such that, even if we did, we still likely would get bad policy together with an ever-growing government sector.

That is why the Austrian economists and the public choice theorists favor smaller government. Especially in today's environment, their insights bear repetition.

—***Bruce Caldwell*** *is Director of Duke University's Center for the History of Political Economy, General Editor of* The Collected Works of F.A. Hayek*, and the author of* Hayek's Challenge: An Intellectual Biography of F.A. Hayek.

This essay was published February 1, 2011.

[33] See Peter Boettke, "Putting the 'Political' Back into Political Economy," in *Economics Broadly Considered: Essays in Honor of Warren J. Samuels*, ed. Jeff Biddle, John Davis, and Steven Medema (London: Routledge, 2001), p. 207. *Cf.* Hayek, writing in the 1956 Foreword to the American paperback edition of *The Road to Serfdom*: "The increasing tendency to rely on administrative coercion and discrimination where a modification of the general rules of law might, perhaps more slowly, achieve the same object, and to resort to direct state controls or to the creation of monopolistic institutions where judicious use of financial inducements might evoke spontaneous efforts, is still a powerful legacy of the socialist period which is likely to influence policy for a long time to come." Hayek, *The Road to Serfdom* (Chicago: University of Chicago Pres, 1956), p. 44).