



# PHILOSOPHY OF ECONOMICS & POLITICS

## LECTURE 8: HAYEK

DATE **26 NOVEMBER 2018**

LECTURER **JULIAN REISS**



# Today's agenda

- \* Today's topic is Hayek, specifically his book *The Road to Serfdom*
- \* As usual, I will talk a little bit about his life
- \* And, in this case, about the enormous political influence he's had
- \* Many of the ideas in *The Road to Serfdom* are direct responses to socialist tendencies he perceived at the time

# Friedrich Hayek

- \* 1899-1992
- \* (Austrian) economist and philosopher (political theory, philosophy of science)
- \* As economist, his main contributions are to:
  - \* The theory of business cycles
  - \* Investment theory
  - \* The economic calculation problem/socialist calculation debate
  - \* Monetary theory (advocate of 'free money')
- \* As political philosopher, he is best known for his defence of classical liberalism
- \* Taught at the LSE, then Chicago (but not in economics!), then in Freiburg



# Friedrich Hayek

- \* 1974 Nobel Prize for his “pioneering work in the theory of money and economic fluctuations and ... penetrating analysis of the interdependence of economic, social and institutional phenomena.”
- \* Tons of further honours:
  - \* Appointed a member of the Order of the Companions of Honour by Queen Elizabeth II in 1984
  - \* U.S. Presidential Medal of Freedom by Bush senior in 1991
  - \* “The Use of Knowledge in Society” was selected as one of the top 20 articles published in *American Economic Review* during its first 100 years in 2011
- \* Enormous political clout: e.g., directly influenced ‘Reaganomics’, Thatcher, Honorary Chairman of the Centro de Estudios Públicos in Pinochet’s Chile

# *The Road to Serfdom*

- \* The title was inspired by – who else? – Alexis de Tocqueville
- \* Recall that among the dangers of democracy he observed in *Democracy in America*, were the negative effects centralisation could have for individual liberty
- \* In later work Tocqueville explicitly commented on socialism
- \* *The Road to Serfdom* can be regarded as a detailed study of the mechanisms through which the desire for equality would lead to the abolishment of individual liberty
- \* The book has received praise across the political spectrum



# Hayek: Main Ideas (on C&D)

- \* I will focus here on three issues that directly connect with our discussion of Schumpeter:
  - \* **The economic viability of socialism:** he (explicitly) disagreed with Schumpeter and provided highly original arguments to the effect that socialism was not **economically** viable
  - \* **The compatibility of socialism and democracy:**
    - \* He argued that totalitarian ideas are not opposed to socialism, but in fact a necessary consequence
    - \* ‘Democratic socialism’, even though he granted that most Western socialists genuinely believed in the idea, to him was an oxymoron
    - \* This is because any form of economic planning (whether aimed at equality or what have you) will eventually undermine democracy because individuals do not agree on values
    - \* Moreover, any large-scale planning will involve infringements of personal or political liberties
  - \* **The survival of capitalism:** he was more optimistic and indeed fought for it

# The viability of socialism

- \* Hayek's views are impossible to understand without discussing the so-called '**socialist calculation**' (aka 'economic planning') **debate**
- \* Started by **Ludwig von Mises** in a 1920 article which argued that because socialism means state ownership of the means of production there can be no markets, with no markets there can be no (non-arbitrary) prices, and without (non-arbitrary) prices, there could be **no rational allocation of the factors of production**
- \* Prominent socialist economists attempted to refute this logic and **demonstrate the feasibility and indeed superiority of socialism** over capitalism
- \* '**Lange model**': uses the mathematical resources of neoclassical economics to portray an economy in which a central planning board allocates investment and capital goods and labor and consumer goods are allocated by markets; the planning board **simulates a market** in capital goods by a trial-and-error process



# Hayek on socialist calculation

- \* 'The Use of Knowledge in Society' (1945)
- \* The economic problem is **not** one of finding a vector of relative prices **given knowledge of everyone's preferences and available means**
- \* Rather: how do we best make use of information given not to any single mind but dispersed across all members of society
- \* Because for most economic decisions the **local knowledge** of the particular circumstances is crucial, **a central planning system will never outperform a system which builds on decentralised markets** in which individuals communicate information through the price system
- \* Models such as Lerner's fail to get to the core of the issue: **they assume information to be 'given' which simply wouldn't be available outside of a market system**



# Socialism Involves 'Economic Planning'

- \* Hayek's argument against the compatibility of socialism and democracy is premised on the assumption that **socialism necessarily involves what he called 'economic planning'**
- \* Planning is 'a **central direction of all economic activity** according to a single plan, laying down how the resources of society should be "consciously directed" to serve particular ends in a definite way'
- \* The contrast is not generally with 'laissez-faire' but **the creation of the conditions under which competition can thrive**
- \* Thus, Hayek did not advocate abolishment of government altogether (as do some libertarians); rather, **the government has important roles** in enabling competition:
  - \* Institutions like money, markets, and channels of information—some of which can never be adequately provided by private enterprise
  - \* Interventions for social problems that cannot be solved by markets (externalities, monopolies)
  - \* Some kind of social insurance



# Socialism Involves 'Economic Planning'

- \* Why does socialism involve planning?
- \* There are two meanings to the term 'socialism' (cf. von Mises 1920):
  - \* **Social justice**, greater equality, security – certain aims of society
  - \* **Abolition of private enterprise**, individual property, and collective planning – the means by which the aims are to be achieved
- \* **The ends cannot really be divorced from the means:** we need planning to distribute incomes equally, whether by regulation or by nationalisation
- \* To exercise economic planning in democratic fashion would require what Hayek called a '**complete ethical code**'



# ‘Complete Ethical Code’

- \* By that he meant, essentially, a **complete agreed-upon preference ranking** over every economic contingency in society
- \* Obviously, **we don’t have any such thing**; we make economic decisions locally, on our knowledge of our specific circumstances
- \* **Majority vote** works for decisions for which there are just a **small number of alternatives**; here the number of alternatives is vast
- \* As for every decision there are losers, **it is impossible to find agreement on most issues**
- \* (Politics should be limited to the sphere of decisions about which there is unanimous or near unanimous agreement)



# Planning Undermines Democracy

- \* Since there won't be agreement on most issues, individuals will defer decisions to some political elite that takes over for them
- \* But disagreements among experts/politicians/representatives will continue until one party takes over and imposes their view on everyone else
- \* Even if the social goal is initially a limited one (e.g., equality of incomes), **coercion will reach more and more spheres:**
  - \* Why should I work in a dangerous occupation if I receive the same salary as everyone else?
  - \* Why should I work at all or if I do, put in any effort?
  - \* Individuals cannot signal that a specific good is highly desired, so the government will have to make decisions about which goods to produce and at what price to sell them – eventually telling people what to consume...



# Planning Undermines Political and Personal Freedoms

- \* And **the problem does not stop at economic decisions** (this is what some socialists made us believe: economic dictatorship which leads to greater freedom elsewhere)
- \* This is because **economic ends cannot be separated from other ends:** money and wealth are ‘all-purpose means’ that enable us to do things we want to do and be the persons we want to be
- \* When there is competition and a supplier or employer rejects me, I can turn elsewhere; this is not possible when the state is an all encompassing monopolist
- \* This means that **freedom of religion, freedom of press and speech, and all sorts of personal freedoms will have to go**
- \* All this is made worse by the fact that in today’s world, because of the high degree of division of labour, few goods are home made



# Finally, Hayek on the Future of Capitalism

- \* Hayek thus believed that only capitalism could assure the continued existence of democracy and freedom
- \* Unlike Schumpeter, who idly stood by its demise, Hayek fought socialist and other anti-capitalist tendencies in society
- \* For example, in 1947 he founded the Mont Pelerin Society, a scholarly community arguing against collectivism
- \* This soon became part of a movement of think tanks aiming to influence policy according to classical liberal ideas (e.g., Institute of Economic Affairs, Manhattan Institute for Policy Research, Atlas Economic Research Foundation...)
- \* This movement is the essence of what today is called 'neoliberalism'
- \* However, what is called 'neoliberalism' is often at best a caricature of the classical liberal ideas Hayek sought to promote