

# INFORMATION, KNOWLEDGE AND THE CLOSE OF FRIEDRICH HAYEK'S SYSTEM: A COMMENT

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To “close” the intellectual system of a significant thinker, the most effective argumentative strategy is to find an internal contradiction in that system. Eugen Böhm-Bawerk’s classic *Karl Marx and the Close of His System* [1896] did just that, by demonstrating the internal contradictions with Marx’s value and distribution theory. Elias Khalil [2002] attempts to follow a similar argumentative strategy against F. A. Hayek. Khalil tries to show that F.A. Hayek’s arguments critical of socialist planning and in favor of the Great Society are not logically derived from his theories of knowledge and information. Khalil does not limit himself to the claim that Hayek’s arguments are simply wrong, but instead insists that the arguments are wrong on *their own terms*. In particular, Khalil makes the rather unusual argument that Hayek does not distinguish between information and knowledge in a coherent manner.<sup>1</sup> From that proposition, Khalil proceeds to argue that Hayek’s argument against socialist planning is based on his theory of dispersed (but objective) information, while his defense of the liberal order is based on his theory of inarticulate (or tacit) knowledge, but the connection between the two is either underdeveloped, or nonexistent. Khalil argues that the critique of planning depends on the costs of collecting information, and thus is not as absolute as Hayek seems to suggest in his writings. Moreover, Khalil argues that Hayek’s defense of the liberal order is based on individualist beliefs that lack the communal core and leadership necessary for a social purpose. Without this communal core and leadership, the liberal order cannot sustain itself. Khalil argues that Hayek’s system is built upon contradictory cognitive arguments, and specifically that neither Hayek’s information critique of economic planning nor his knowledge argument defense of liberalism works to establish the case that he thought they did. This allows Khalil to conclude that Hayek has not provided a non-ideological theory for determining the superiority of one social system of production (namely capitalism) over alternatives (namely socialism).

Contrary to the theoretical agnosticism that Khalil intends his argument to thrust upon us, if the century plus debate on the theory and history of socialism has taught us anything, it is that certain institutional prerequisites must be in evidence if large-scale economic activity is to be expected to generate efficient production and generalized prosperity.<sup>2</sup> There simply are no analogous institutions to private property, free

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pricing, and profit and loss accounting for generating the incentives and information required for advanced material production in the mechanisms outside the institutional setting of a market economy. We can, then, make definitive statements about social systems of production, at least in this abstract sense. It is my contention that, contrary to Khalil, we can make these statements in a scientific manner largely (though certainly not exclusively) because of the research and writings of F. A. Hayek.

Ironically, while Khalil is attempting to show that Hayek is caught in an internal contradiction, he also does not want to expend the intellectual energy on restating Hayek's argument faithfully to Hayek's own body of work. This move is justified by Khalil because he hopes to avoid an analysis of what Hayek really meant, and instead wants to 'rationally reconstruct' his argument so he can assess its coherence with regard to the critique of socialism and the defense of the liberal order. Unfortunately, Khalil's effort is misguided because he "rationally reconstructs" the wrong argument. In a fundamental sense, one cannot assess Hayek's argument without getting that argument right, and it is my contention that Khalil has not gotten the argument right. This is not an issue of hagiography, but of critical assessment. One of the most effective ways to engage a system of ideas is to step inside that system and develop an imminent critique [Caldwell, 1982]. But to accomplish that critical exercise, the position being criticized must be stated correctly and clearly. The most important point to emphasize with regard to Khalil's effort is that Hayek did not draw the distinction between information and knowledge in his work the way that Khalil attempts to do, and thus his attempt to "close" Hayek's system fails.

Khalil's error is the result of a "neoclassical" reading of Hayek's "Use of Knowledge in Society" paper, which tries to force-fit Hayek's insights about the nature of the price system into a search theory framework. Certainly the element of search in a world of imperfect information is part of the Austrian analysis of the market process, but it does not exhaust market theory in this tradition.<sup>3</sup> Knowledge consists not just of bits of information, but the interpretation and judgment required in acting on those bits of information as well.<sup>4</sup> When Hayek argued that the market system utilizes knowledge, he was not restricting his argument to the limited, though important, insight that prices economize on information. By summarizing the terms of exchange, prices do indeed economize the information we must process in making choices in the market. Hayek's famous tin example illustrates this economizing role by showing how price adjustments guide us toward aligning our actions with relative scarcities of resources even though we may remain ignorant of the underlying cause of the price adjustments. But Hayek also argued in that essay that the price system utilizes "knowledge of a kind which by its nature cannot enter into statistics" [1948, 83] and that the preoccupation with the equilibrium state of affairs habitually disregards "the unavoidable imperfection of man's knowledge and the consequent need for a process by which knowledge is constantly communicated and acquired" [1948, 91]. Hayek's argument is not limited to one that emphasizes the use of information that is dispersed among economic actors in a society. Instead, his argument is an *epistemological* argument about how certain institutional settings enable the discovery, use, and communication of knowledge essential for the coordination of disparate plans of economic actors.<sup>5</sup>

To clarify, Hayek's position is that within a certain institutional environment, the price system does indeed utilize dispersed information efficiently, as well as accomplish other vital tasks. Prices, by summarizing the existing terms of exchange, provide economic actors with *ex ante* information about how they should orient their actions, and profit and loss statements provide *ex post* information on the appropriateness of previous decisions. The discrepancy between the *ex ante* and the *ex post* informs actors that they must adjust their behavior and *discover* better ways to arrange their affairs than they had before if they hope to succeed in fulfilling their plans.<sup>6</sup> The crucial argument to the Hayekian system is that absent the context of the *price system* and the knowledge that *that* system engenders knowledge would not exist. In other words, the knowledge utilized in the market economy is *contextual* by its very nature and does not exist outside of that context.<sup>7</sup> This aspect of Hayek's argument was explicit in his analysis of the Lange-Lerner "competitive-solution" model when discussing the marginalist conditions necessary for optimality. As Hayek states, "The fact is that it has never been denied by anybody, except socialists, that these formal principles *ought* to apply to a socialist society, and the question raised by Mises and others was not whether they ought to apply but whether they could in practice be applied in the absence of a market" [1948, 183]. None of the market socialist writers, Hayek contended, have shown how the values that would satisfy the optimality conditions could be found using some process other than competition based on private property.<sup>8</sup> In other words, the marginalist principles in practice are the by-product of the market process, not behavioral postulates prior to that process.<sup>9</sup>

The market economy in Hayek's system of thought does not owe its advantages to its ideal efficiency, but instead to its adaptive properties in the face of current inefficiencies. Interpreted narrowly, the "neoclassical" understanding of the price system overestimates the informational efficiency of equilibrium prices, as various writers in information have repeatedly shown [Grossman and Stiglitz, 1980], and underestimates the informational content of *disequilibrium prices* which engender a process of adaptation and adjustment of individual plans to realize the mutual benefits of exchange.<sup>10</sup> Khalil's critique of Hayek on planning draws on misreading Hayek in a narrowly "neoclassical" way, and thus relies on a variant of the informational economics critique of the market economy. But as I have argued, this argument, while representing an interesting challenge to that orthodox reading, fails to address Hayek's position in the debate. As a result, Khalil's critique of the information-based argument against economic planning is just misplaced when dealing with Hayek's critique of various models of socialist planning.

The second target of Khalil's critique of Hayek's system is Hayek's well-known humility based defense of the liberal order. Liberalism is favored in Hayek's system because it doesn't suffer from a "pretense of knowledge." Hayek's intellectual nemesis was "constructivist rationalism" and he sought (using Hume's phrase) "to whittle down the claims of reason by the use of rational analysis" [1960, 69].<sup>11</sup> Hayek did not seek to denigrate reason; in fact, he argues repeatedly in his work that reason is man's most precious possession. But his work attempted to defend reason against its abuse by those who failed to grasp the institutional conditions required for its effective functioning and continuous growth. In this way, Hayek sought to provide a justification

for the indispensable role of various traditions that must be accepted to achieve a free society.

Despite his claims, Khalil does not demonstrate that Hayek's economics and politics are built upon distinct arguments about information and knowledge. Instead, if we take Hayek's starting point in economics as the question of the coordination of plans within an advanced economy, then we can see how questions of the institutional backdrop against which decisions are made will influence the ability of actors to realize a better or worse coordination of their activities. Hayek's work as an economist led him to emphasize how economic actors must utilize their knowledge of time and place in making decisions. How the market system is able to achieve such a high degree of order in the absence of command leads Hayek, the political economist, to emphasize generality in the law and politics and the requisite constraints on discretion, for it is only against the backdrop of the general rules of property, contract, and consent that actors are able to exploit their local knowledge in a way that is translated in a mutually beneficial way to other participants within the system so they can also utilize their local knowledge, and plans are better coordinated. "What is essential to the functioning of the process is that each individual be able to act on his particular knowledge, always unique, at least so far as it refers to some particular circumstances, and that he be able to use his individual skills and opportunities within the limits known to him and for his own individual purposes" [1960, 29].

Khalil's argumentative strategy fails on its own terms to deal critically with Hayek's system. While it is accurate to state that knowledge and information can be treated as analytically distinct, they are not so treated in Hayek's writings. And, where the term information is deployed by Hayek, it is most often used in the broader knowledge sense we have been discussing [Hayek, 1979, 190 footnote 7]. The recognition of our cognitive limitations is at the core of Hayek's politics and economics. The "constitutional limitations of man's knowledge and interests" led Hayek to emphasize in his writings how specific institutional configurations may induce individuals, by their own choices and responding to their own situations, to contribute to the satisfaction of the needs of others [1948, 13-14].

By focusing our analytical attention on our cognitive imperfections, Hayek sought to articulate how we can cope, and in fact exploit, this situation to realize the unforeseen and unpredictable from which we will benefit as the course of events unfolds through time.

If there were omniscient men, if we could know not only all that affects the attainment of our present wishes but also our future wants and desires, there would be little case for liberty. And, in turn, liberty of the individual would, of course, make complete foresight impossible. Liberty is essential to leave room for the unforeseeable and unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims. It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independent and competitive efforts of many to induce the emergence of what we shall want when we set it. [1960, 29]

In making this *epistemic*-based case for the liberal order, Hayek did not see himself as deviating from the argument put forth by the 17<sup>th</sup> century Scottish Enlightenment thinkers whom he was following.

The main point about which there can be little doubt is that Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they are now, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid. [1948, 11-12]

This "robustness" aspect to Hayek's political economy is completely ignored in Khalil's examination [cf. Boettke 2000, xxv-xxix].

In short, it is my contention that Khalil fails in the task that he has set for himself. He has misinterpreted the main points about Hayek's theory of the market process as articulated in his 1945 essay, and he therefore artificially draws a distinction between Hayek's economics and politics. Obviously Hayek recognizes different types of cognitive limitations that we face in our social intercourse—sometimes we know too little, other times we think we know what in fact we don't, and still other times we don't even know that we don't know. But in Hayek's framework we experience these (and other) cognitive limitations in all walks of life. To say that Hayek's argument against planning is about cognitive complexity, while his argument for a liberal political order is about the growth of knowledge, as Khalil (section 4) wants to suggest, is to fundamentally misconstrue Hayek's basic message about the discovery and use of the knowledge of time and place, and the institutional prerequisites which enable that process to be a source of our growth rather than frustration.

## NOTES

I would like to thank the editor of this *Journal* for the opportunity to respond to Khalil's article and his comments on an earlier version of this paper. In addition, I would like to acknowledge the useful comments of Tyler Cowen, Daniel Klein, David Prychitko, and John Robert Subrick on an earlier version. The financial support of the J. M. Kaplan Fund to support my research is gratefully acknowledged. The usual caveat applies.

1. The argument is unusual because the literature on Hayek has emphasized the differences between the understanding of the role of prices within a market economy that follows from information economics and market process economics [Kirzner, 1979; Thomsen, 1992].
2. See Boettke [2000] for a 9-volume reference collection of the main texts in the debate over socialism. The introduction to this collection attempts to summarize how the terms of the debate have shifted over the years and the main conclusions that can be drawn from the debate.

3. See Jack High [1990] for an examination of search theory and, in particular, its limited application in addressing the dynamic adjustment processes of a market economy.
4. Dividing knowledge into the triad of information, interpretation and judgment has been emphasized by Daniel Klein and I borrow that distinction from him for my purposes in this paper. See Klein [1999] for a discussion of discovery and entrepreneurship.
5. Boettke [2000] emphasizes the unity of Hayek's work from his early work on trade cycle theory to his political philosophical work on the liberal order. In this interpretation the comparative institutional analysis conducted on the basis of *epistemic* grounds is the primary contribution that Hayek's system offers to modern political economy. Also see Boettke [2001, 29-46].
6. Khalil emphasizes the distinction between "discover" and "create", where "discover" is meant to be limited to finding objective information, while "create" is about the creation of information that previously did not exist. In the context of the argument developed by Hayek, this distinction is not so neatly drawn. The discovery of a hitherto unknown opportunity for mutual beneficial action is also often an act of creation. On the subtleties with these terms and their economic significance see Kirzner [1999].
7. On how even the most "objective" facts of economic life are embedded within a inter-subjective web of meaning in Hayek's understanding see his essay "The Facts of the Social Sciences" reprinted in Hayek [1948, 57-76].
8. Boettke [2001, 29-46] details the intimate connection between Mises's argument about impossibility of economic calculation in the socialist commonwealth and Hayek's argument on the use of knowledge in society.
9. This filtering mechanism of the competitive market process has been emphasized by writers such as Machlup, Alchian and Hayek. Hayek, in particular, in his essay "Economics and Knowledge" [1948, 33-56] emphasizes that the knowledge required for the obtainment of equilibrium cannot be assumed to be in the possession of economic actors prior to its obtainment, but must be explained as the outcome of the process if we hope to have a nontrivial theory of economic equilibrium. Also see Hayek's discussion of competition and rationality in *Law, Legislation and Liberty*, III [1979, 75-77]. For a textbook presentation of this filter mechanism within the context of a price searcher model of the competitive market process see Heyne, Boettke and Prychitko [2002, Chapters 9-10].
10. See my review of Stiglitz's *Whither Socialism?* [Boettke, 1996]. Also see Caldwell [1997] for an examination of Hayek and the debate over socialism from the market socialists of the 1930s to the information theoretic arguments of today.
11. The critique of rational constructivism is evident throughout Hayek's writings from at least his "The Trend of Economic Thinking" [1933] to *The Fatal Conceit* [1988]. His most comprehensive examination of the subject is in *The Counter-Revolution of Science: Studies on the Abuse of Reason* [1952].

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