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**HAYEK AND ECONOMIC POLICY  
(THE AUSTRIAN ROAD TO THE THIRD WAY)**

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# **Hayek and Economic Policy**

## **(The Austrian Road to the Third Way)**

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### **Abstract**

By examining Hayek's approach to economic policy, this paper tries to show that his understanding of a free-market society was ambiguous, if not contradictory. Hayek was indeed following the Austrian tradition by rejecting technocratic views of policy-making. Nevertheless, he advocated a constitutional approach ultimately based on the rule of law created behind a veil of ignorance. Regulation and a fairly extensive welfare state are not ruled out either, and are subject to evaluation through a mix of rule of law (what that means), public opinion, common sense.

After close inspection of the Road to Serfdom, the Constitution of Liberty, Law, Legislation and Liberty this contribution concludes that not only does Hayek fail to provide clear answers to the fundamental questions of economic policy. He also advocates a Third Way characterised by enlightened social engineering. In particular, the state has the duty to provide a suitable framework for the individual to develop his action, and to meet those social needs that the market fails to satisfy.

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# **Hayek and Economic Policy**

## **(The Austrian Road to the Third Way)**

### On Hayek's view of economic policy

The debate on the scope and moral foundations of economic policy began as soon as economics strived to become something more than just a branch of political philosophy and attempted to acquire its own identity as a social science. By and large, its Founding Fathers characterised this discipline as being concerned with how individuals behave and interact in order to enhance their well-being. This justified the use of the term 'political economy', to emphasise the role of the institutional context within which human action takes place. Towards the end of the XVIII century prominent authors went further and suggested that political economists should not be confined to the mere description and explanation of human action. Nor should they refrain from recommending how institutions ought to be designed and modified in order to enhance welfare<sup>1</sup>. Adam Smith was of course a leading and effective supporter of this approach<sup>2</sup>, which actually owed much to Galiani and, to a lesser extent, Quesnay.

At the beginning of the new century Say forcefully advocated the need for a sharper partition between the realms of political economy and of policy, the former referring to the study of human action under given institutional rules; the latter to the rules of the game. He did not exclude the importance of normative economics. Still, this branch was to remain an exercise in simulation, with little or no room for decision-making by the economist. Later on, the same perspective was also typical of Walras and of a number

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<sup>1</sup> See Fontaine (1996). As will be clarified later on, Hayek (1960[1978]) definitely subscribed to this view. More recently, a similar approach was also advocated by Buchanan (1979), who insisted on the notion of economics as a system of voluntary exchange generated by - and giving origin to - agreed-upon rules. These rules are named institutions and represent an essential feature of economic analysis.

<sup>2</sup> Smith's vision is not entirely clear, though. For instance, Grampp (2000) argues that Adam Smith supported a free market system because he believed this to be the best way to promote the social good – in his case the accumulation of national wealth and military power. As a matter of fact, this would explain why Smith did not hesitate to claim that natural rights and individual freedom should be set aside when the public good - e.g. national power or even fairness - is at stake. Hayek will devote the whole Epilogue of (1979 [1981]) to justifying his rejection of a natural-right approach.

of more recent authors. Lionel Robbins, for instance, understood policy-making to be dependent on moral judgement; and thus unacceptable if economics was conceived as a way of reasoning and an instrument to understand individual or group behaviour. Indeed, he argued that it would make little sense to use a logical tool in order to derive normative prescriptions. In Harry Johnson's words, it would be unreasonable and probably counterproductive (see Tyszynski 1955 and Mackintosh 1950).

Contrary to Say, Hayek chose not to consider normative economics as a mere exercise in simulation with little practical relevance. At the same time, however, he was also unwilling to accept the technocratic approach based on descriptive, a-theoretical economics and scenarios. Not surprisingly, while trying to find out a suitable compromise between socialist planning and (unconditional) free-market capitalism, he stumbled into a dilemma. On the one hand he could draw on the early foundations of political economy and follow the 'constitutional economics' approach. As made explicit by Buchanan (1979) and, more generally, by most of the public-choice and the ordoliberal schools, since economic action takes place within an institutional framework, the economist should analyse the features of an optimal context, so as to enhance voluntary exchange and widen the choices available to the agents. In other words, economy policy should propose constitutional solutions aimed at reducing transaction costs, while leaving individuals more or less free to adopt or reject such solutions. When the notion of social contract is added - which implies that it exists, that its elements are well specified and that all the members of a community are required to act in accordance with them - this a-moral version of policy-making develops into normative prescriptions for the production of the goods and services described in the social contract.

Another possibility open to Hayek was related to the existence of social norms, informal behavioural patterns emerged over long time periods and generally subject to varying degrees of enforcement. In some cases norms have become ways through which individuals identify their position in society (e.g. manners). In other cases - and more important for the scope of these pages - they are a means to reduce the cost of cooperation within a community of interacting individuals. In the past informal arrangements were characterised by repeated trial and error experiences within relatively close communities. Tradition and customs would thus gradually reveal the

nature and stringency of social norms. Surely, little room was left to ambiguity or to the discretion of the would-be policy-maker. If anything, politics was just a synonym for the procedure through which selected individuals were given the power to enforce compliance with the social norms.

Predictably, the conceptual gap separating social norms from policy-making is hard to bridge, even for Hayek. Whereas social norms do reflect an informal social contract originating from repeated voluntary interaction and trial-and-error processes, policy making at its best is a way to anticipate the results of the social contract that individuals would subscribe to if they had enough time to appreciate its terms<sup>3</sup>. In other words, policy-making at its best is about guessing the terms of the social contract and – in an ideal world – conjecturing about those who would be willing to sign it.

In the end, and for reasons that remain largely unexplained<sup>4</sup>, Hayek opts for a view of economic policy which consists of a set of spontaneous rules supplemented by artificial norms created by government and cleared by ‘legislators’<sup>5</sup>. Their purpose is to replicate – or, rather, anticipate – social norms. Although he does not frequently mention it with the clarity that the subject deserves, this argument refers to the so-called ‘acceleration of time’<sup>6</sup>. This situation materialises as informal institutions tend to come to the surface only gradually, so that their evaluation through a trial-and-error process becomes too slow to be of significant use, especially when the features of the problems to be solved through individual interactions change rapidly. Under such circumstances, timely top-down rule making (policy making) can be desirable and replaces slow

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<sup>3</sup> Note that this notion of the social contract is different from that advocated by Buchanan (1979). According to the argument developed in the text, Hayekian policy-making reflects a social contract that would have emerged as a consequence of a spontaneous, time-consuming process leading to a social norm. On the other hand, in Buchanan’s view the social contract is what the individuals would have chosen had they been behind a veil of ignorance.

This view presents two major weaknesses, though. First, policy-makers cannot possibly know what individuals would choose behind the veil of ignorance. Second, people do not choose behind a veil of ignorance; indeed, the history of mankind can be described as the continuous effort to reduce the size of the veil before taking a decision.

<sup>4</sup> Even Caldwell (2004) provides very little information on this account.

<sup>5</sup> Hayek’s notion of ‘Legislative Assembly’ is in fact what one would currently label as ‘Constitutional Court’. See in particular (1978 [1981, chapter 17]).

<sup>6</sup> See Hayek (1973 [1983, pp.88-89]; 1960 [1978, p.286]) and, more generally, Denzau and North (1994) and Fiori (2002).

bottom-up rules. Hence, the Hayekian enriched version of constitutional economics does not preclude freedom to choose, but admits coercion when geared to reproducing a social contract that the acceleration of time makes hard to perceive.

By and large, this defines Hayek's project for a liberal society, away from *laissez-faire* and - in his view - strong enough to resist socialist attacks. And also explains why from the end of the 1930s Hayek tried to find ways to replicate/anticipate a plausible social contract, and then to justify it without using constructivism. The pages that follow examine these efforts in some detail and conclude that the results attained are far from persuasive. Economic policy always requires the definition of the shared goals and priorities, of the tools to be employed and of the policy-maker in charge of implementation. Unfortunately, Hayek's work remains somewhat wanting on the legitimacy of both the instruments and the actors; and thus ambiguous. If so 'he has no complete theory of the social order to back up his liberal recommendations', which contributes to making 'modern liberalism vulnerable to erosion and invasion by incompatible elements' (De Jasay (1996, p.107).

#### Hayek's views on policy action

Consistent with the Austrian tradition, Hayek deals with economic policy as a social philosopher, rather than as an economic technocrat or a political theorist. In particular, he focuses on the aims of policy-making in a society where human dignity and thus liberty are supposed to be the primary moral component, and proposes to 'design the most rational permanent framework within which the various activities would be conducted by different persons according to their individual plans' (1944 [1979, p.26]). It is therefore manifest since the beginning of his intellectual journey that although some elements of such framework are the legacy of the past (customs, traditions, implicit contracts), Hayek also considers other elements, which stem from human design and are conceived through a procedure of 'consensus behind a veil of ignorance', whereby the social designer cannot act in order to benefit or damage specific individuals or groups deliberately. Compliance with this procedure provides legitimacy to policies, so as to protect and/or reproduce the results generated by the appropriate set of long-

term, stable social norms that would have emerged spontaneously if agents had not been hindered by transaction costs or surprised by the acceleration of time, as aired earlier.

In fact, Hayek's offensive against economic policy is weaker and less comprehensive than may appear at first sight. It is a Third Way between *dirigisme* and *laissez faire* where the state plays two roles: (i) it provides a framework where individual action develops and (ii) it meets those social needs that the market fails to satisfy because of externalities<sup>7</sup>. It happens to be illegitimate only when it becomes the instrument of discretionary bureaucratic interference with the social norms (loosely understood as a synonym for social contract) - both directly, through rules issued by the bureaucrats themselves; and indirectly, when bureaucrats arbitrarily enforce the rules conceived by the social philosophers or by the politicians<sup>8</sup>. Although this is surely an important limitation, it is not enough to deter Hayek from advocating state funds in favour of generalised education, sanitation, minimum-income legislation, adequate infrastructure, information, quality control, sporting and cultural activities, collective insurance *vis-à-vis* catastrophic, unpredictable events<sup>9</sup>. And also behavioural rules that should not replace individual preferences (1973 [1983, p.51]), but nevertheless shape human action and make it easier to predict. In short, the state is 'a piece of utilitarian machinery intended to help individuals in the fullest development of their individual personality' (1944 [1979, p.57]). Unfortunately, one does not know how to assess when the state helps spontaneous development and when it drives such development: 'Unlike classical liberalism that confines the state to the provision of a single public good, law enforcement, Hayek's social order is less, rather than more, clear-cut: it permits, if not

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<sup>7</sup> Indeed, Hayek often fails to distinguish between an externality *stricto sensu* and a residual explanation for why allegedly desirable states of the world fail to materialize. Therefore, since he believed that direct state intervention is justified - if not required - whenever externalities are relevant and widely recognized, government intervention ends up by being appropriate whenever the state of the world could be improved with no obvious costs. More on this at fn. 21.

<sup>8</sup> According to Hayek (1960 [1978, p.112-115]) the politician does not have ideas and should merely represent conventional thought: 'His task in a democracy is to find out what the opinions held by the largest number are, not to give currency to new opinions which may become the majority view in some distant future' (ibid. at p.112). On the contrary, the social philosopher is an intellectual innovator who conceives new, possibly welfare-enhancing ideas or general principles that agents may or may not accept.

<sup>9</sup> See Hayek (1944 [1979, pp. 89-90], 1960 [1978, pp.141,144, 223, 257, 258, 364, 365, 375, 383], 1978 [1981, chapter 14]). On the other hand, some doubts on the existence of natural state monopolies are aired in (1979 [1981, p.147])

positively mandates, the state to produce any number in any quantity' (De Jasay 1996, p.113).

Put differently, although Hayek emphasises the crucial role of liberty, he reasons that nothing useful can come to birth in a vacuum (which he wrongly considers a synonym for *laissez faire*). And hastens to fill in the vacuum by appealing to common sense, search for compromise, expediency. By holding on to these two arguments (individual liberty and *horror vacui*) and carefully avoiding to discuss the intrinsic conflicts, Hayek's well-known condemnation of scientism actually excludes bad policy-making, rather than policy-making *per se*; and leaves plenty of room for social, piecemeal engineering, to be carried out by enlightened political action applied to economic activities. He therefore succeeds in attracting consensus from the anti-socialist ranks when attacking scientism and positivism, i.e. historicism, objectivism and the foundations of socialism (Saint-Simon and Comte). And in enticing those who believe in the existence of the common interest, a notion that Hayek believes can be defined by means of an idealised version of majoritarian democracy<sup>10</sup>. It is hard to say whether Hayek himself was aware of the blurred border between general rules (constitutional law making by enlightened, possibly arrogant political philosophers<sup>11</sup>) and detailed rules (scientism by rational and selfish bureaucrats or shortsighted politicians). He must have had serious fears, though; since after (1960 [1978]) he repeatedly tried to keep the two categories apart and explain - without much success, in our view - why public-choice analysis applies to the latter but not to the former.

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<sup>10</sup> Hayek seems to have mixed feelings about democracy, that vary from unqualified praise (see the Constitution of Liberty) to scepticism. He will then solve his doubts by distancing himself from the current version of democracy (*cum* unlimited governmental powers) and suggesting a concept closer to that predating the French Revolution – demarchy (*cum* constrained governmental powers). His ideal political construction is fully detailed in Hayek (1978 [1981]), where democracy is somewhat naively described as ‘a certain framework for arriving at political decisions, and tells us nothing about what the aims of government ought to be’ (p.98).

<sup>11</sup> In some cases the Constitution should spell out and thus impose principles that are ‘too unfamiliar to expect courts to comprehend’ (1979 [1981, pp. 148-149]).



## Between bad socialism and good policy-making

As the previous pages suggest, according to the main thesis put forward in this article Hayek's view on economic policy depends heavily on his idea of a society of free individuals protected by super constitutional arrangements. These arrangements should be the absolute barrier against socialism and the growing conviction that governments ought to play a major part in shaping people's daily life (1944 [1979, p.9])<sup>12</sup>. This is little more than a façade, though. For Hayek's view the real problem with socialism is not so much the violation of individual freedom, as collectivisation. This approach has two consequences. It does not oblige Hayek to confront natural rights and the sacredness of private property (which he is not willing to accept); and leaves the door open to non-socialist coercion, to be applied whenever the results are not satisfactory:

‘in the ordering of our affairs we should make as much as use as possible of the spontaneous forces of society, and resort as little as possible to coercion ... There is [...] all the difference between deliberately creating a system within which competition will work as beneficially as possible, and passively accepting institutions as they are. Probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rules of thumbs, above all the principle of *laissez-faire*. Yet in a sense this was necessary and unavoidable .... Nothing short of some hard-and-fast rule would have been effective. And since a strong presumption in favour of industrial liberty had been established the temptation to present it as a rule which knew no exceptions was too strong always to be resisted’ (ibid., p.13).

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<sup>12</sup> Hayek held *laissez-faire* responsible for this state of affairs. He maintained that its alleged success in the XIX century led people to take the results of market forces for granted and concentrate on collective goals (ibid., p.15).

Curiously enough, a few years later Hayek's connection between *laissez faire* and socialism disappeared, and a large part of the Counter-Revolution of Science was actually devoted to showing the links between rationalism, positivism and ultimately socialism. Hayek (1960 [1978, p. 60] finally closed the circle by saving the classical –liberal school. He followed Renan's view on liberalism and maintained that *laissez faire* actually originated from Rationalism ‘as the very words show’ - rather than from the classical-liberal tradition. Did Hayek truly believe that the radical Austrian school was a by-product of the French Revolution?

and

‘There were many tasks [...] where there could be no doubt that the government possessed enormous powers for good and evil; and there was every reason to expect that with a better understanding of the problems we should some day be able to use these powers successfully’ (ibid., p.14)

Unfortunately, Hayek does not attempt to clarify who has to decide about the features and desirability of the exceptions, or how the decision-making process should take place. Nor does he explain when better knowledge of the problems legitimises government to use its coercive powers<sup>13</sup>. For instance, after having warned the reader about the dangers of government intervention, he makes it explicit that ‘where it is impossible to create the conditions necessary to make competition effective, we must resort to other methods of guiding economic activity’ (ibid., p.27), even if that implies expropriation or compulsory purchase (1978 [1981, p.62-63])<sup>14</sup>. The same applies to monopolies (ibid., pagg.29 and 147) as well as to a variety of other situations.

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<sup>13</sup> As we know, the challenge had already been raised by the libertarian school - from Rothbard to de Jasay and Hoppe - and it involved the difference between Saint-Simon’s Council of Newton on the one hand, and Hayek’s custodians of the rule of law on the other. Hayek’s reply was elusive. In the *Road to Serfdom* (ch. XV) he believed that an international authority should take care of drafting and enforcing proper rules at a supra-national level (constitutional engineering once again). He later addressed the question at a national scale, but the answer provided in (1978 [1981]) - elected assemblies of highly paid representatives - defined the nature of the problem once more. Surely, it did not solve it. He also favoured moderate decentralisation among competing local agencies in the provision of public services, subject however to centralised control as regards legitimacy. Both the central and the local agencies are also expected to compete with the private sector (1978 [1981, pp.47,49], except for the fact that the latter has no right to cover costs through taxation.

<sup>14</sup> This position is not too far from what the Saint-Simonians were advocating a little more than a century earlier. Indeed, although Hayek strongly opposed the Saint-Simonian attitude towards private property (1952 [1979, chapter 13]), when it comes to choosing between freedom and expropriation he opts for the latter. His justification is that ‘we still lack adequate theoretical principles for a satisfactory solution of some of the problems which arise in this field’ (1978 [1981, p.63]).

More generally, Hayek sometimes does not seem to have a very clear idea about free-market principles. When it comes to inheritance taxes, for instance, it is obvious that the liberal argument against taxation focuses on the fact that taxation interferes with the parents’ desire to sacrifice their own consumption in order to enhance their children’s welfare. Taxation is indeed a tax on altruism or family affection. Surprisingly, however, Hayek criticises inheritance taxes by referring to their inefficiency, rather than their immorality (1960 [1978, chapter 6]). Other examples are provided by his view of competition, which is unfair if a successful producer ‘keeps out a potential competitor by offering specially favourable terms to customers only in the limited region in which a newcomer at first will be able to compete’ (1979 [1981, p.84]). Or by his support for progressive income taxation based on the fact that indirect taxation is necessarily regressive (1979 [1981, p.127]).

Hayek's view about economic policy is thus characterised by two essential and persistent elements: the need to develop some kind of constitutional engineering and to adjust for externalities, which justify state coercion, as explained at length in (1960 [1978]). The former turns out to be not only desirable, but also necessary, if a market economy is to generate the best possible results. The latter is always welcome, as long as intervention remains within the boundaries set by the rule of law. In a word, as long as the rule of law is not violated, government intervention is admitted and leads to the production goods and services (e.g. insurance services against catastrophic events and unemployment), the redistribution of income by means of taxation (including substantial inheritance taxes) and the regulation of production (1944 [1979, p.60])<sup>15</sup>.

The core question then clearly revolves around Hayek's notion of the rule of law, defined as a set of 'rules fixed and announced beforehand – rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge' (see for instance 1944 [1979, p.54] and 1973 [1983, p.108]). Apparently this definition does not include freedom of contract, since

'to limit working hours or to require certain sanitary arrangements is fully compatible with the preservation of competition ... nor is the preservation of competition incompatible with an extensive system of social services – so long as the organisation of these services is not designed in such a way as to make competition ineffective over wide fields' (1944 [1979, p.28]).

Hayek will indeed modify his view later on, when the emphasis moves from certainty and predictability to the notion of just conduct, 'as a means for assisting in the pursuit of a great variety of individual purposes'<sup>16</sup>. But his argument basically remains

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<sup>15</sup> See also the third part of (1960 [1978]) and (1978 [1981, chapter 14]) for a complete list of Hayek's public goods, which includes even entrepreneurship ('certain experimental developments' to use his own words). Hayek (1960 [1978, chapter 6]) will subsequently change his mind about inheritance taxes. And he will also deny that being part of a national group justifies compulsory income transfers (ibid., pp. 101-102).

<sup>16</sup> See also (1976 [1978, p.5 and 37]): 'The chief function of rules of just conduct is thus to tell each what he can count upon, what material objects or services he can use for his purposes, and what is the range of actions open to him'. Hayek (1973 [1983, pp. 2-3]) was aware of the fact that the rule of law raised some problems as an operational device, but attributed them to a lack of understanding, rather than to the conceptual weakness of the very notion.

an attack against privileges or burdens for selected interest groups known in advance<sup>17</sup>, and an appeal for a political system that creates stable rules behind a veil of ignorance<sup>18</sup>. Sometimes the veil drops, though. For Hayek also conceives an ideal world where a set of desirable features must be in place (including the absence of externalities). The lack of such features is characterised as market failures, and the state is called upon to fill the gap and cover the costs through taxation: ‘far from advocating [...] a minimal state, we find unquestionable that in an advanced society government ought to use its power of raising funds by taxation to provide a number of services which for various reasons cannot be provided, or cannot be provided adequately, by the market’ (1978 [1981, p.41]). Furthermore, ‘There are common needs that can be satisfied only by collective action and which can thus be provided for without restricting individual liberty’, and ‘There is no reason why the volume of these pure service activities should not increase with the general level of wealth’ (1960 [1978, p.257]). As a result, Hayek’s spontaneous order is no longer an alternative to rationalism, but a desirable situation where repeated interactions may have given birth to patterns of predictable behaviour and where order (i.e. predictable behaviour) has to be enhanced on a case by case basis, whenever it does not appear spontaneously<sup>19</sup>. As De Jasay (2004) has recently pointed out, in Hayek’s view

‘the market, law and its enforcement must first secure property and contract against violation, and then the market order will spontaneously emerge as a result of individual interactions within this framework of safety and predictability. [Put differently,] law is a product of collective choice and so is its

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<sup>17</sup> See for instance (1976 [1978, p.137]).

<sup>18</sup> See also (1976 [1978, p.132]). Of course, even the abolition of a bad rule – for instance trade barriers – would violate Hayek’s notion of the rule of law, for it would provoke damages to selected strata of the population. Not even Hayek could deny that the victims and the beneficiaries of a transition to a free trade-regime would be clearly identified. In fact, Buchanan’s position is easier to understand, in that he introduces the veil of ignorance not to justify economic policy, but to justify the social contract that implies economic policy. There is no doubt that the veil of ignorance is a more effective rhetoric device to justify the ends of the individual signing the social contract, rather than to explain the ends and means of government intervention.

<sup>19</sup> See (1973 [1983, p.36 and chapter 5]) and (1973 [1983, chapter 2]). A similar logical twist also characterises Hayek’s view of the welfare state as compatible with (his version of) the rule of law and thus with free-market principles, including subjectivism (1944 [1979, pp. 89-91]). This approach is of course rejected by the orthodox Austrians à la Mises who are critical of top-down government action; and also by the Ordoliberalists, who criticise his piecemeal approach – see in particular Vanberg (1996).

enforcement ... Hayek's spontaneous order, then, is not spontaneous, for it includes the government as a necessary condition, and government action is purposive'.

Surely, Hayek is well aware of the fact that extensive state action might distort individual behaviour. But he is inclined to elude the problem by arguing that when this happens, then it means that privileges are being created and the rule of law violated. Put differently, on the one hand the reader is being told that economic policy is welcome when the market fails. On the other hand he is warned that economic policy is not acceptable when it creates winners and losers and thus distorts incentives.

#### Hayek's need for a social contract

As mentioned in the previous paragraphs, from the late 1930s Hayek was suggesting that market-oriented economic policy was to be preferred to central planning. But the need for economic policy, and for sensible policy making as a whole, was not questioned.

More generally, Hayek criticised the Middle Way, but also hurried up to recommend allegedly neutral, state solutions to hypothetical market failures. Unfortunately, he did not see that such failures called for property-right solutions. This blindness prevented him from grasping the notion of externality<sup>20</sup>, deprived his conception of rule of law of the only intellectual anchor it could count on - the principles of 'private property and freedom of contract' (ibid., p.28) - and forced him to apply rule of law according to rather questionable common-sense principles (opinion and 'universalizability', to be explained shortly). As one may have noticed, Hayek correctly refrains from referring to spontaneous order; for it would be incompatible with not-so spontaneous rules of the game, which are however desirable according to the

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<sup>20</sup> In Hayek's view an externality is the effect of one's action on other individuals (see 1978 [1981, p.43-44]). Since he could not argue that all actions provoking disappointment or envy need to be regulated or require compensation, compliance with his notion of the rule of law needed to be assessed case by case, following common sense. Surprisingly, Hayek never refers to a negative externality as an encroachment on somebody else's property right.

Hayekian vision. Once again, when discussing competition he adds that ‘we cannot, within the scope of this book enter into a discussion of the very necessary planning which is required to make competition as effective and beneficial as possible’ (ibid., p.31). And when arguing for redistribution and a minimum welfare state, he is not sure whether they should be justified in order to buy consensus against special interest (ibid., p.156)<sup>21</sup>, or just because not having it is a deficiency:

‘some security is essential if freedom is to be preserved’ (1944 [1979, p.99]) and ‘adequate security ... will have to be one of the main goals of policy’ (ibid., pp. 98-99).

‘capitalism as it exists today has many remediable defects that an intelligent policy of freedom ought to correct. A system which relies on the spontaneous ordering of forces of the market, once it has reached a certain level of wealth, is also by no means incompatible with government providing, outside the market, some security against severe deprivation’ (1976 [1978, p. 136]).

The logical weakness of this position can only be overcome by introducing new conceptual tools. Authors like Leoni (1961 [1991]) and de Jasay (1985 [1998]) clearly perceived that the only instrument that social scientists can use in order to reach a compromise is the social contract. Indeed, Buchanan’s success owes a great deal to having assumed a social contract, irrespective of its moral foundations (legitimacy). Hayek never mentions it explicitly and actually denies its validity<sup>22</sup>. In fact, he replaced the social contract with the rule of law, the difference between the two being the same as that between a state ruled by bureaucrats with discretionary power<sup>23</sup> and one composed by social philosophers (politicians) with the monopoly of violence. More subtly, by sidestepping the discussion on the social contract, Hayek could actually treat

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<sup>21</sup> Oddly enough, Hayek does not perceive the contradiction embedded in his argument. If the beneficiaries of the welfare state can be classified as ‘special interest’, then the Hayekian welfare state is in contrast with Hayek’s fundamental rule-of-law criterion. On the other hand, if the beneficiaries are not special interests, it is not clear why traditional pressure groups should be satisfied by the welfare state and feel that no more rent-seeking activities should be pursued.

<sup>22</sup> See (1960 [1978, chapter 4]) where Hayek states that the very notion of social contract is the fruit of Rationalism, and thus unacceptable for any follower of the Scottish Enlightenment - including Hayek himself, of course.

<sup>23</sup> See also Hayek (1960 [1978. ch.13]).

it as a fact, rather than a serious concern for the social philosopher: ‘constitutions are based on, or presuppose, an underlying agreement on more fundamental principles – principles which may never have been explicitly expressed, yet which make possible and precede the consent and the written fundamental laws’ (1960 [1978, p.181]).

As a by-product, this ‘underlying agreement’ explains and justifies the state monopoly of violence: ‘Coercion, however, cannot be altogether avoided because the only way to prevent it is by the threat of coercion. Free society has met this problem by conferring the monopoly of coercion on the state’ (ibid., p.21)<sup>24</sup>. And legitimacy is now maintained by reference both to the veil of ignorance, following the lines already sketched in the Road to Serfdom:

‘Even where coercion is not avoidable, it is [...] being made impersonal and dependent upon general, abstract rules, whose effects on particular individuals cannot be foreseen at the time they are laid down. [...] Coercion [...] then becomes an instrument assisting the individuals in the pursuit of their own ends and not a means to be used for the ends of others’. (ibid.).

and to a new concept - opinion - defined as

‘ a common tendency to approve of some particular acts of will and to disapprove of others, according to whether they do or do not possess certain attributes which those who hold a given opinion usually will not be able to specify. So long as the legislator satisfies the expectation that what he resolves will possess those attributes, he will be free [...]’ (1973 [1983, p.92])<sup>25</sup>.

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<sup>24</sup> This view brings Hayek much closer to Hobbes and away from the classical liberals. Indeed, a classical liberal or a libertarian would never believe that a politician or a bureaucrat could pursue the private interest better than the individual involved and independent of the individual’s opinions on the matter.

<sup>25</sup> See also (1976 [1978, p. 14]), where the concept of opinion is suggested as the driving principle to evaluate the legitimacy of policy action, i.e. to draw the line between arbitrary interference and intervention within the rule of law.

## A Manifesto against freedom

When encouraging policy-makers to intervene and enhance the acquisition of knowledge, improve on bad past legislation and question defective traditions, gain consensus, Hayek did perceive the problem of misuse of power:

‘restraints [...] on the power of the legislator could, of course, be made more effective and more promptly operative if the criteria were explicitly stated by which it can be determined whether a particular decision can be a law. But the restraints which in fact have long operated on the legislatures have hardly ever been adequately expressed in words.’ (1973 [1983, p.93])<sup>26</sup>.

Still, his call for explicit rules defies centuries of political history, while his proposal to submit the legitimacy of the new rules to the test of ‘universalizability’ remains elusive<sup>27</sup>. For either the policy-maker is in fact just proposing social arrangements that may reduce the cost of human interaction and that individuals are free to accept or reject, possibly through a trial-and-error process characterised by competition in an evolutionary context. Or the policy-maker has the right to impose such social arrangements as long as they may be qualified as moral<sup>28</sup>.

One can of course answer by arguing that all the arrangements conceived behind a veil of ignorance are welcome by agents. Which is hardly credible, even from a purely Hayekian viewpoint. It doesn’t take much to see that the politician does not necessarily use his power of coercion to minimise transaction costs in a society, that he never operates behind a veil of ignorance, let alone his knowing how people would behave and what they would choose behind the veil. Another possibility to avoid to choose is to

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<sup>26</sup> See also (1976 [1978, pp.28-29]).

<sup>27</sup> The test of ‘universalizability amounts to a test of compatibility with the whole system of accepted rules [...] which may either lead to a clear ‘yes’ or ‘no’ answer or may show that, if the system of rules is to give definite guidance, some of the rules will have to be modified’ (1976 [1978, pp.28-29]).

<sup>28</sup> Hayek (1960 [1978]) explains that institutions are ‘convention and customs of human intercourse’, which involve a moral code as well as general and ‘unconscious adherence to moral rules’. Therefore, coercion is not necessary only ‘when individuals can be expected as a rule to conform voluntarily to certain principles’ (p.62). At the same time, Hayek is aware that coercive rules are deplorable and are not conducive to desirable evolution. This is why they ‘can be broken by individuals who feel that they have strong reasons to brave the censure of their fellows’ (p.63). Indeed, the author could not have done better to confuse his readers. See also *ibid.* at p. 67, 146-147 for yet other views of the same subject.



claim that institutions come from the past, as a result of tradition and spontaneously-developed rules. Following our previous terminology, from this viewpoint the social contract has not been agreed upon, but has been revealed through history (1960 [1978, chapter 4]). Therefore, one may infer that the policy-maker is not a social philosopher designing social arrangements, but one interpreting and enforcing the allegedly revealed social contract by transforming it into a law. Unfortunately, it is not clear what happens if different social scientists have different perceptions as regards revelation. And not many classical liberals would agree with Hayek's notion whereby 'liberalism regards it as desirable that only what the majority accepts should in fact be law' (ibid., p.103)<sup>29</sup>.

Similar remarks apply to the notion of individual freedom, often quoted as the bulwark against arbitrary policy-making. In this case Hayek departs from the classical-liberal position based on the familiar notion of 'freedom from coercion'<sup>30</sup> and refers instead to the concept of responsibility: 'freedom, namely a state in which each can use his knowledge for his purposes' (1973 [1983, pp.55,56]). In particular, 'the argument for liberty [...] presupposes that a person is capable of learning from experience and of guiding his actions by knowledge thus acquired' (1960 [1978, p.77]). Thus, liberty is no longer a (natural) right, but almost becomes part of a social contract, whereby in order to deserve it, one must show that he/she is able to profit from it. Once again, the policy-maker creeps in through the back door to assess whether individual behaviour is consistent with a contract that also requires that 'in our decisions as to whether a person is to be his own master or be subject to the will of another, we must regard him as [...] either having or not having the right to act in a manner that may be unintelligible, unpredictable or unwelcome to others' (ibid., p.78)<sup>31</sup>.

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<sup>29</sup> The fact that he also writes that 'it is not obvious that this same majority must also be entitled to determine what it is competent to do' or that liberalism 'accepts majority rule as a method of deciding, but not as an authority for what the decision ought to be' hardly contributes to clarifying matters. See ibid. at pp.107 and 104.

<sup>30</sup> Hayek (1973 [1983, p.61, 62]) justifies his departure from the classical liberal lines by claiming that they were too vague to serve any operational purpose: '*Laissez-faire* [...] never provided a criterion by which one could decide what were the proper functions of government'.

<sup>31</sup> Hayek suggests infants and idiots as examples of individuals that do not deserve liberty. Nevertheless, the notion of learning from experience and guidance of actions is much wider and goes well beyond those categories.

This departure from Austrian subjectivism plays an important role, since it allows Hayek to cry out against coercion and still favour constitutional constructivism. For in Hayek's world individual A is subject to coercion not only if other individuals exercise physical or psychological violence towards him, but also if they refuse to act according to A's wishes and such a refusal can jeopardise A's existence (ibid., p.136). This statement has two important implications. First, it means that individual freedom is not valuable *per se*, but only if it is compatible with other agents' basic needs. How basic a basic need is remains of course a matter open to debate. For instance Hayek mentions the owner of a spring in an oasis and claims that he should offer free water to all those who cannot pay and are about to die. The owner of the spring may indeed decide to do so out of compassion. But he cannot be obliged to do so - as Hayek advocates - unless one violates the principle of private property. And also two other principles. One is responsibility, since those who adventure in the desert without enough water should take responsibility for their poor organisation or sheer bad luck. The second is the principle of entrepreneurship (and the ethics of profit), which would make sure that agents strive to find new wells, look after care of the existing oases, possibly establish a network of relief stations in the desert<sup>32</sup>.

Other examples of the effects implied by Hayek's notion of coercion apply to monopoly power and the labour market. In the former case regulation is required whenever 'a monopolist is in a position to withhold an indispensable supply' - be such an action a fact, or just a possibility (ibid., p.136). It is easy to observe that this idea is very close to that of 'dominant position', which today pervades mainstream economics: 'whenever there is a danger of a monopolist's acquiring coercive power, the most expedient and effective method of preventing this is probably to require him to treat all customers alike, i.e. to insist that his prices be the same for all and to prohibit all discrimination on his part' (ibid., p.136)<sup>33</sup>. In the latter case Hayek welcomes regulation

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<sup>32</sup> Both principles recur frequently in Hayek's works. But they seem to be forgotten when it comes to their policy implications.

<sup>33</sup> See also (1979 [1981, pp.84-85]), where the need for government action against price discrimination is argued forcefully. It may be worth pointing out that today not even socialist policy-makers would object to price discrimination.

‘in periods of acute unemployment’, when workers may be induced to accept unfair contracts (ibid., p.137).

In short, individual liberty for Hayek means protection against coercion, and coercion means not only violence as commonly understood, but also resistance to the rule of law and need. And since for Hayek (1960 [1978]) taxation and compulsory military service are the outcome of - or at least compatible with - the rule of law, resistance against both turns out to be an act of coercion<sup>34</sup>. Put differently, the difference between the Hayekian and the socialist versions of acceptable coercion turns out to depend on how the social welfare function is defined. In the former case state intervention is justified when it enforces rules (of just conduct) or dominant-position conditions are feared<sup>35</sup>; while in the latter intervention is legitimate whenever it is consistent with the social welfare function in general. But one suspects that the Hayekian definitions of rules or of potential dominant position are almost as arbitrary as any other is.

To conclude, Hayek’s recipe to make policy-making subject to the rule of law and to rely on state violence in order to eliminate coercion is not very persuasive. In his view the rule of law is in fact equivalent to a mix between constitutional straitjackets to restrain ordinary legislation, plus decision-making behind a veil of ignorance and according to general principles, with the purpose of inducing individuals to behave in a predictable way. The fragility of the veil of ignorance has already been mentioned earlier on. As regards general principles, Hayek (1960 [1978, ch. 10]) argues that they should not be created, but just discovered, since ‘they have grown through a gradual process of trial and error in which the experience of successive generations has helped

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<sup>34</sup> See ibid., p. 143 and also De Jasay (1995 [2002, p.87]), who observes that ‘Hayek, in making this singular distinction between coercive and noncoercive government actions, appears to be classifying taxation as noncoercive, a judgement that has an obvious bearing on his position regarding redistribution’.

<sup>35</sup> For some unexplained reason, this also applies to roads and sanitation (ibid., p.141), information (ibid., p.144), some kind of education and the advancement of knowledge in certain fields (ibid., p.223), which Hayek treats as if they were public goods and thus ‘a recognised field of public effort’. See also (ibid., pp. 222-223) for the government production of public goods through general taxation, as long as the benefits cover the cost and ‘provide a favourable framework for individual decisions’.

to make them what they are' (ibid., p.157)<sup>36</sup>. This is the task of the legal scholars, whereas legislators *stricto sensu* should play the role of the benevolent policeman, and 'create conditions in which an orderly arrangement can establish and ever renew itself' (ibid., p.161). In fact, Hayek replaces collectivism with some kind of enlightened policy-making, where neoclassical technocrats are to assist legal scholars, and legal scholars are supposed to establish what the rule of law is and make it explicit. In particular, they define when individuals are subject to state coercion. On the other hand, technocrats are meant to think of effective remedies when deviations from the rule of law are to be corrected and to enforce such amendments<sup>37</sup>.

### Policy-making beyond the rule of law

Contrary to common belief, the role of state intervention in a Hayekian world is not confined to enforcing the rule of law and restraining the use of violence (coercion) by ordinary legislators and technocrats at large. Although one wonders whether state authorities would actually listen to legal scholars telling them what they can and what they cannot do (and hope that legal scholars all share the same opinion and resist the temptation to please state authorities), Hayek goes further and emphasises that coercive activities 'will never be the only functions of government [...]. [I]nfringements of the private sphere will be allowed [...] in instances where the public gain is clearly greater than the harm done by the disappointment of normal individual expectations' (1960

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<sup>36</sup> They reader may observe that Hayek also claims that at times traditional conventions and norms can be broken, for they should not be considered binding, after all. Unfortunately, Hayek provides no clear indication as for when a tradition is non-binding and when it is rule of law. Hence, although the idea of the legislator as a finder is appealing, it still begs the question of establishing the nature of what the finder has actually ascertained.

<sup>37</sup> Indeed, Hayek does not ignore that history has provided plenty of examples whereby constitutions have degenerated, also thanks to having introduced the separation of powers, as he notes when discussing the French and German cases (1960 [1978, chs.12-13]). Still, rather than drawing the obvious conclusions about the impossibility of constitutional constructivism, he simply concludes that such examples demonstrate the need for further safeguards.

[1978, pp. 206, 218])<sup>38</sup>. The implications are not really clarified or examined in any detail.

Indeed, while Hayek squeezes the debate on the aims and legitimacy of economic policy into a question of rule of law, he says almost nothing about the instruments through which policy is to be carried out<sup>39</sup>. He therefore reduces normative economics to a matter of personal judgement by the social philosopher. In turn, economic policy acquires strong social-democratic connotations, as rules must ‘tell people which expectations they can count on and which not’, but ‘it is clearly impossible to protect all expectations ... which expectations must be protected must ... depend on how we can maximise the fulfilment of expectations as a whole’ (1973 [1983, pp.102-103]). In Hayek’s view that seems to be enough to justify breach of contract *vis-à-vis* employers (pickets and strikes)<sup>40</sup>, taxation (to finance poverty-relief programs, social security, compulsory health insurance, agricultural improvements<sup>41</sup> and constitutional design).

Hayek does try to draw the line between the socialist welfare state and his own: the former being one where the taker decides about the amount of redistribution,

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<sup>38</sup> Quite astonishingly, Hayek (1960 [1978, p.218]) suggests that the willingness of the public administration to compensate the individual is an acceptable criterion to compare private losses and public gains. He seems to forget both that civil servants carry out compensation by using somebody else’s money and that fair compensation is actually established by the buyer (the civil service). As a matter of fact, Hayek seems to be more interested in ‘fair socialism’, rather than individual freedom.

See also De Jasay (1995 [2002]) for a critical analysis of Hayek’s position and ambiguities on redistribution and the welfare state.

<sup>39</sup> True enough, Hayek does claim that policy action should not tamper with prices or quantities. That is hardly satisfactory, though. Income taxes do affect the relative price of human capital, while it is difficult to accept that according to a free-market approach ‘subsidies are a legitimate tool of policy, not as a means of income distribution, but only as a means of using the market to provide services which cannot be confined to those who individually pay for them’ (1960 [1978, p.264]). Indeed, Hayek is advocating redistributive justice within a market system steered by allegedly wise policy makers caring for the common good and possibly constrained by general rules set by equally wise legislators.

<sup>40</sup> See (1960 [1978, p. 275]).

<sup>41</sup> According to Hayek (1960 [1978, chapter 23]), farmers should be subsidised, since they lack access to good information. And ‘We all have an interest in our fellow citizens’ being put in a position to choose wisely ...; the question as to which of these services will be worth while and to what extent they should be carried is one of expediency and raises no fundamental issues’. (ibid., p.366).

whereas the latter is one where the givers do<sup>42</sup>. But of course, it is not clear what happens if a giver decides to give relatively little – or nothing at all; nor is it clear whether the Hayekian system is compatible with a democratic regime<sup>43</sup>. In the end, Hayek seems to be less hostile to planning than meets the eye<sup>44</sup>, as long as good planning is enforced and bad planning rejected. In the case of town planning, for instance<sup>45</sup>, good planners help the functioning of the market and operate through equitable compensation mechanism and set reasonable standards. Whereas bad planners enforce rules (without compensation) and engage in arbitrary decision making. After all, that is what a constructivist would argue: bad outcomes are the product of bad planners, rather than of the very attempt to plan human activity.

### Concluding remarks

During the XX century the economic profession grew more and more interested in exercises in social efficiency, whereby the economic policy-maker was to define sets of efficient solutions to assigned problems, and the politicians were supposed to choose the best option. The illusion of the benevolent policy maker and the true nature of the relation between redistribution, incentives and economic performance were exposed only in relatively recent times. Hayek's role in this endeavour could hardly be overestimated.

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<sup>42</sup> Up to a point, though, for Hayek seems to replace socialism with populist pragmatism: 'the defraying out of the common purse of the costs of services which will benefit only some of those who have contributed to it will usually be agreed upon by the rest only on the understanding that other requirements of theirs will be met in the same manner, so that a rough correspondence of burdens to benefits will result' (1973 [1983, p.140]). The same concept is repeated, for instance, in (1976 [1978, p.7]).

<sup>43</sup> Hayek is of course for democracy, as long as people are reasonably well educated by institutions free from political interference. Still, rather than being an argument supporting democracy, it sounds more like one for compulsory education financed by taxpayers' money, or for lifetime employment for state teachers (1960 [1978, chapter 24]). See also (1973 [1983, p.3]) and, more generally, (1978 [1981]), where Hayek mentions the broken promises of democracy. Nevertheless, the obvious and somewhat troubling consequences for his argument are not drawn and he offers instead a 'better' political constitution.

<sup>44</sup> Caldwell (2004, p.238) already noted Hayek's early inclinations beyond individual planning, which make him sound 'suspiciously like what the later Hayek would consider a social constructivist or, at the very least, a constitutional political economist'.

<sup>45</sup> See (1960 [1978, chapter 22])

Still, the lesson has not been learnt, let alone applied (Nelson 1987). This contribution has tried to argue that Hayek himself bore some responsibility in this intellectual defeat, for his recipes were based on an enlightened version of economic policy (to be driven by suitable social philosophers), more or less restrained by a new constitutional order<sup>46</sup>. More important, Hayek did not centre his research program on a clear and well-founded justification for policy-making, but rather on the constant effort to confine policy-making within reasonable, common-sense boundaries. Such boundaries are of course Hayek's definition of the rule of law, which however proves to be unsatisfactory on two accounts. On the one hand, Hayek fails to provide a proper characterization: as a consequence, the rule of law turns out to be little more than a set of principles defined behind a veil of ignorance, possibly in accordance with a curious version of the freedom-from-coercion principle. The term 'possibly' should remind the reader that the Hayekian rule of law is in fact compatible with some redistribution, taxation, state production of goods and services and equitable compensation. When commenting on Hayek's view of the welfare state, De Jasay (1991, pp. 15-16) is thus justified in claiming that 'here is a clear call [...] to re-create something like the "Swedish model" under the liberal banner. Horrified as Hayek would be by the imputation of such a proposal, his exposition is fully consistent with it, and must be classed as "loosely liberal" for that reason'. On the other, he denies the principle of spontaneous order when spontaneity is not adequate or desirable: 'there can be no justification for representing the rules of just conduct as natural in the sense they are part of an external and eternal order of things, or permanently implanted in an unalterable nature of man' (1976 [1978,pp.59-60]). As for assessing whether the rules of the game are appropriate or consistent with just conduct, his reference to legitimacy being based on public opinion cannot be taken seriously<sup>47</sup>.

Of course, by looking at today's world one can maintain that both Hayek's and Chicago-style liberalism describe an ideal, utopian picture. The first boils down to some kind of benevolent elite of social philosophers in charge of policy making, while the

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<sup>46</sup> As Caldwell (2004, p.206 and 289) notes, Hayek thought this to be one of his major achievements, and the answer to Keynes' objections to his work in the area of political philosophy.

<sup>47</sup> 'The power of the legislator [being derived] from a state of widespread opinion concerning the kind of rules he is authorized to lay down' (1976 [1978], p.60).

latter is obsessed by the notion of equilibrium and overlooks transaction costs and entrepreneurship. Still, whereas the Chicago approach is wrong, but consistent, Hayek's world of constitutional engineering is fragile from the very beginning, for it is rooted on the same rules of the game that legitimate and therefore lead to discretionary power. To deny this is equivalent to denying the very behavioural hypotheses of human action, which Hayek observed in Western Culture and learnt from Mises (1948 [1963]). As we know, the alternative is a world featuring institutional competition, ultimately based on a notion of freedom originating from natural-right principles. Unfortunately, this is a vision to which Hayek sometimes agrees when advocating methodological individualism and – even more – Austrian subjectivism. But which he eventually neglects in order to be able to engage in 'constitutional economics'.

In this respect, Hayek's divergence from Mises is hard to explain. Hayek's ongoing efforts not to confront Mises on major issues doesn't help, either<sup>48</sup>. Perhaps, Hayek may have wanted to stop short of shocking his readers or the policy-makers as a whole, and thus avoid the very mistake he reproached to the classical liberals and the *laissez-faire* school. This is surely a feature throughout the Road to Serfdom, where he fails to elaborate a persuasive criterion to evaluate the legitimacy of economic policy<sup>49</sup>. And becomes explicit in the 1970s, when he claimed that 'attempts to push a principle further than general sentiment is yet ready to support it is apt to produce a reaction which may make impossible for a considerable period even what more modest attempts might have achieved' (1976 [1978, p.58]). One wonders, however, whether an alleged champion liberal thought should advocate accuracy and cohesion, or settle for political suitability and offer some kind of a Third Way composed of a piecemeal list of government actions to meet specific goals in the economic sphere, the only perceptible policy criterion being one of consistency with the prevailing notion of just conduct. The price Hayek paid was however high. Not only was he forced time and again to appeal to expediency within a microeconomic context, and to go as far as denying some fifty years of Austrian business cycle economics by claiming that 'it is merely common sense

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<sup>48</sup> See Caldwell (2004).

<sup>49</sup> Even his rule-of-law criterion starts to shake when he recommends that most wartime restrictions be kept in place for years to come (p.155), without even bothering to explain why.



that government [...] will step in when private investment flags, and thereby employ resources for public investment at the least cost and with the greatest benefit to society' (1978 [1981, p.59]). More important, 'the effect of leaving out pieces from the jigsaw puzzle of social theory is that the vacuum is only too naturally filled by a false conception of the state. This conception is hardly compatible with liberal principles. Indeed, it is hardly compatible with the very market order that Hayek wants to be spontaneous' (De Jasay 1996, p.118).

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