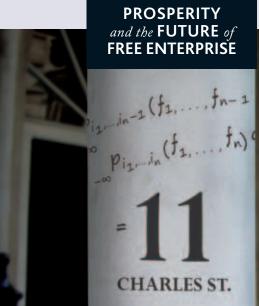


THE LEGATUM INSTITUTE Charles Street Symposium





CHARLES STREET SYMPOSIUM | DECEMBER 2013 What Would Hayek Say Today (Really)?

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Preface

The ideas of Friedrich August von Hayek have left a significant footprint on economic thought and policy debates of the last century. But do his ideas still matter? In the wake of the 2008 financial crisis there has been a resurgence of interest in Hayek's work on business cycles, but its policy lessons have been largely ignored by policymakers. Much of his other scholarly work remains largely ignored or, worse yet, misunderstood.

In the past his ideas mattered greatly. In the face of stagnating economies of the Soviet bloc and the economic malaise in the West in the 1970s, Hayek's vision represented a stark alternative to the dominant consensus about the role of the government in the economy. The reforms of the Thatcher and Reagan years, as well as the radical reform strategies used in post-communist transitions were influenced by Hayek, and are generally seen as successful in restoring life to previously moribund economies.

But what would he and the wider 'Austrian School' of economics say about the modern challenges facing the globalised world economy? How would he have seen the current financial crisis as it continues to unfold? Did Hayek's support of non-price distorting redistribution and mandate policies mean that he would have endorsed universal healthcare? Would Hayek have seen a need for intellectual property protection in the increasingly interconnected world? What would he have seen as the challenges to nations which are endeavouring to transition towards democracies and market economies?

The 2013 Charles Street Symposium explores such questions to better understand the relevance of Hayekian economic and social thought for the 21st century. This publication presents the written works of twelve exceptional young scholars who endeavour to answer those questions.







HAYEK AS A FOUNDATIONAL THINKER

The Problem of Possibility: Competitive Governance as a Discovery Procedure

Zachary Caceres, Executive Director, Startup Cities Institute, Universidad Francisco Marroquín.

F. A. Hayek and the Reason of Rules

Stefan Kolev, Professor of Economics and Economic Policy, West Saxon University of Applied Sciences Zwickau. Managing Director of the Wilhelm Röpke Institute, Erfurt, Germany.

Can The Law Rule? The Need to Consolidate Third and Fourth Wave Democracies During Economic Recession

Eszter Nova Ph.D., Political Economy Fellow, Financial Research Institute, Budapest.





The Problem of Possibility: Competitive Governance as a Discovery Procedure

Author:

ZACHARY CACERES

Executive Director Startup Cities Institute Universidad Francisco Marroquín In this essay, I argue that within Hayek's work we can find an important but underappreciated idea I call "the Problem of Possibility." Put briefly, this problem is that complex evolutionary systems like economies face astronomically large 'design spaces' that they must search for adaptive fit. This augments Hayek's traditional arguments about the challenges of ignorance and complexity in political economy. Rapid adaptation of a social system requires competition for scientific, not ideological or moral reasons.

First, I describe this problem using an allegory taken from biology and complexity theory. Second, I argue that this problem forms a key tenet of Hayekian political economy. Finally, I briefly conclude that 'the Problem of Possibility' in Hayekian political economy suggests a commitment not just to competitive markets in economic goods, but to a higher-level competitive market in law and governance.

"... [T] he economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place."

F.A. Hayek in The Use of Knowledge in Society"

SEARCHING THE LIBRARIES OF BABEL, MENDEL, AND SMITH

In 1944, Jorge Luis Borges wrote a short story called the Library of Babel. It's a metaphor that many have since used to understand evolution—especially natural selection's remarkable exploration of biological complexity.¹

He asks us to imagine a library of all possible 500-page books—every possible 500-page book that could be written in the English language. We could remove this limit and expand the library arbitrarily.

The vast majority of the Library of Babel is, well, babble.² The library contains a complete list of all possible combinations, and as you might expect, most of those are nonsense.

But in the Library of Babel there is also an accurate collection of Shakespeare. There's the Bible and *Don Quixote*. The Library of Babel is truly massive: the number of books far exceeds the number of atoms in the universe.

We have a big problem in the library: it's hard to find the books that make any sense in the mass. The readable novel gets lost in the sea of babble.

The technical name for the Library is a 'design space'. Obviously, it's purely theoretical—we can't visit. But the 'designs' contained in these books are all the logical possibilities of combinations contained within the constraints of the given system—in this case: 500-page books in English.

How could we possibly find the needle in the haystack? Where do we find the books that exhibit sense or 'order' in the library?



Daniel Dennett uses this allegory for biology.³ This design space of biological life is searched by Darwinian selection over long periods of time.⁴ DNA, rather than English letters and words, are the contents of the books.

Natural selection sifts through these combinations. Only some forms of life have fitness for their environment. These are adaptive and persist in the long run. All 'nonsense' life forms die. Darwinian competition is our search strategy. Over time, we find our way through the library by sorting out the babble.

THE PROBLEM OF POSSIBILITY

Economist Eric Beinhocker uses this allegory to understand markets. He calls the design space of an economy the Library of *Smith*. This library contains every possible business plan, made of technologies both physical (e.g. assembly lines) and social (e.g. limited liability corporation), rather than DNA or 500-page books.⁵

All of these libraries are part of a broader issue we'll call 'the Problem of Possibility' (henceforth 'The Problem').⁶ Within a sufficiently complex system, agents are faced with the task of coping with an astronomical number of possible combinations of adaptive fit in their environment. They have no way of knowing ex ante which combinations are adaptive and which are not.⁷

Unfortunately for those browsing the library, any 'book' chosen at random will almost certainly be noise rather than signal. It will be non-adaptive and fail. The challenge for agents, and for the system as a whole, becomes: how can we search these libraries of possibility for the signal in the noise, as quickly as possible?

One argument is that we need markets not for 'efficiency' but to cope with the Library. We need the trial and error of competitive businesses to search the huge Library and find the plans that have adaptive fit. 9 When others discover this fit, the whole system will benefit. 10

Although this argument fits nicely with his other remarks about ignorance, it is not the typical 'knowledge problem'

that many attribute to Hayek. 11 But 'the Problem'— searching spaces where most designs are non-adaptive noise—is a powerful complement to these ideas.

Hayek clearly understood this problem, though he did not describe it in this way. In the Constitution of Liberty he writes,

Every organization is based on a given knowledge; organization means commitment to a particular aim and to particular methods, but even organization designed to increase knowledge will be effective only insofar as the knowledge and beliefs on which its design rests are true ... and if any facts contradict the beliefs on which the structure of the organization is based, this will become evident only in its failure and supersession by a different type of organization.

In short, if we can only learn if a book is babble by taking it from the shelf and reading it, then the faster we can sort through the failures, the faster we can arrive at adaptive fit. ¹³

'The Problem' cannot be solved with technology, by central planning, or by anything other than finding an effective search strategy to work through the library as quickly as possible.¹⁴

Here we find a foundation for Hayek's classical liberalism: monopolistic systems are ruled out as ineffective search algorithms¹⁵ This decision is not political preference or ethics—it's a scientific response to the problems of large design spaces.

We need organisations to fail so that we can learn. ¹⁶ The only way to cope with 'the Problem' is through trial and error in vigorous competition.

CLASSICAL LIBERALISM, COMPETITION, AND THE LIBRARY OF HAYEK

"Competition", wrote Hayek, "is important primarily as a discovery procedure whereby entrepreneurs constantly search..." ¹⁷ Competition is for "discovering facts" that "would remain unknown" without it.¹⁸ Without competition we face ignorance—untamable, and ever-growing.¹⁹

But Hayek says, "organisations are based on a particular knowledge" not just "businesses". 'The Problem' is not





just an economic problem. It's a problem—perhaps the problem—of Hayekian political economy. ²⁰

Hayek was not a dogmatic classical liberal, but an evolutionary theorist who recognized 'the Problem':

The argument for liberty is ... an argument against all exclusive, privileged, monopolistic organization, against the use of coercion to prevent others from trying to do better.²¹

For Hayek, there are two ways to structure a social system: one where "alternative ways based on different views or practices may be tried" and another, "in which one agency has the exclusive right and the power to prevent others from trying."

Hayek's argument against monopoly is an argument for coping with 'the Problem': ²²

It is only when such exclusive rights are conferred on the presumption of superior knowledge of particular individuals or groups that the process [of evolution] ceases to be experimental and beliefs that happen to be prevalent at a given time may become an obstacle to the advancement of knowledge. ²³

If any organization is based on a particular knowledge, and that particular knowledge is likely to be 'falsified' by the overall environment—because conditions change and because it's chosen from the unfathomably huge and noise-dominated design space—then legal systems and governments also face 'the Problem'. Any given institutional arrangement is likely to be noise, not signal.

This may sound jarring to classical liberals who have convinced themselves of the merits of a particular institutional order.

Hayek believed the details of a liberal order were still open to change. He refers to "our great ignorance of the optimum forms of delimitation of various rights" despite our "confidence in the indispensability" of private property. Today's rules are refined "from continued trial and error of constant 'experimentation' in areas wherein different orders contended."²⁴

"Traditional concepts of property rights", says Hayek, "have in recent times been recognized as a modifiable and very complex bundle whose most effective combinations have not yet been discovered in all areas." ²⁵

This gives us a final allegory, which we might call the Library of Hayek.

This Library contains every combination of technologies, physical (e.g. voting machines, surveillance) and social (e.g. simple majoritarianism, common or civil law), that could constitute a social order. We'll call its contents 'constitutions' rather than books. In essence, this is a huge design space of social orders.²⁶

If we take 'the Problem' seriously, and we see how it leads to Hayek's strictures against monopolistic organization, then why shouldn't we also extend this argument to constitutions and social orders themselves?

In short, Hayek's classical liberalism is not just a commitment to private property liberalism per se. It's a commitment to a higher-level rule about building systems that allow humanity to cope with uncertainty, ignorance, and 'the Problem'. Private property is the backbone of a particularly powerful system, markets, that allows us to cope with this problem in the economy.

But if we take this commitment seriously, Hayek leaves the door open to all forms of organizational experimentation—including the legal and public policy organisations that structure markets themselves.

If we must have vigorous competition, failure, and trial and error to learn; if we cannot tolerate monopoly because it traps us in a corner of the Library; then the question that Hayek poses for the 21st century is: What does a world of competitive law and governance look like? This is the logical extension of his ideas, and there is no more relevant economist than Hayek on this frontier.



REFERENCES

- Richard Dawkins appropriated this image for his book Climbing Mount Improbable (1996) where he called it the Museum of All Possible Shells
- Examples include: a book of the letter 'A' repeated over and over for 500 pages.
 A book that's entirely blank. A book of all letter Bs, and a book that says the
 word 'dog' over and over again for 500 pages. An accurate biography of your
 life, including things that haven't happened to you but will. A biography of your
 life with a few details wrong.
- 3. Appropriately, he calls it the Library of Mendel.
- Chapter 35, Intuition Pumps and other Tools for Thinking (2013) citation, also Darwin's Dangerous Idea (1995)
- See especially pgs. 233-239 in The Origin of Wealth (2006). The schema-reader that interprets business plans in Beinhocker's example are management teams. Two excellent arguments about combinatorial evolution that form the basis of this part of the argument are: The Nature of Technology (2009) by W. Brian Arthur and What Technology Wants (2010) by Kevin Kelly.
- 6. Another way of describing this situation is in the language of "The Infinite Series" coined by Virginia Postrel in The Future and its Enemies (1998) or "The Adjacent Possible" coined by biologist Stuart Kauffman. See Kauffman's remarks on the subject at: http://www.edge.org/conversation/the-adjacent-possible
- For example, the Library of Babel has approximately 10^1,000,000 combinations.
- In fact, to an outside observer this process would seem maddeningly inefficient. The virtue of markets is not in their efficiency in this view, but in their ability to cope with failure.
- Pg 279-297, Eric Beinhocker in *The Origin of Wealth* (2006). Some will notice the
 affinity here between Beinhocker's Hayekian argument and the work of Armen
 Alchian on firms and evolution. Firms do not maximize—they face too much
 uncertainty to have the final data to maximize anything. Instead, they grasp,
 they search, they try to find positive feedback that signals adaptive fitness,
 Alchian, A. A. 1950. Uncertainty, Evolution and Economic Theory. *Journal of Political Economy* 58: 211-221.
- 10. One might say, 'as though led by an invisible hand'.
- 11. Indeed, knowledge is dispersed and local and therefore inaccessible to highly centralized organisations. But some people challenge Hayek's arguments about dispersed knowledge by suggesting that a 'future supercomputer' could gather the relevant data to a central authority. Traditionally, Hayekians retreat to Michael Polanyi, arguing that much of this local knowledge is tacit and therefore could never be shared. The Problem of Possibility is a much more difficult issue.
- 12. Notice the use of 'design' here. Pg 37. Constitution of Liberty (1960). Readers may notice that the overall problem and model being constructed here maps onto scientific discovery quite well. See for example, The Logic of Liberty (1969) by Michael Polanyi, Conjectures and Refutations (1962) by Karl Popper, and "The Theory of Complex Phenomena" in The Critical Approach in Science and Philosophy, M. Bunge, ed. (1964). Hayek titled the first section of Chapter 2 in the Constitution of Liberty, "Civilization and the Growth of Knowledge." Philosopher of science Imre Lakatos would publish Criticism and the Growth of Knowledge (1965) shortly thereafter. Although these titles are likely a coincidence. the connection is not. Hayek's arguments in this part of CoL are fundamentally epistemological. Hayek had spent years engaging with the philosophy of science, especially through his relationship with Karl Popper.

- "The Problem of Possibility" is a modern contribution of complex systems theory to natural sciences and the philosophy of science. This essay is a small attempt to map the language of design spaces back onto Hayek's arguments about complex social systems.
- 13. It's worth noting that in the highly competitive market of technology start-ups, the motto of many entrepreneurs if 'Fail Faster'. The agents in this complex system have internalized the Problem of Possibility so deeply that their quite Hayekian search strategy has become a slogan. See The Lean Startup (2011) by Eric Ries.
- 14. There are technical issues, too long to go into here, that further support this point. For example, if social systems like markets are computationally irreducible (i.e. cannot be reduced to a formula that allows the analyst to 'cheat' and see the end result), then the fastest way to search the design space will be the speed of the system itself: the universe. If we speed up our own pace of iteration, we arrive at provisional answers more quickly. But there are no shortcuts to predicting the future in irreducible systems like these. Design spaces are also constantly expanding as the novelty-generating process of combinatorial evolution takes place. For further reading on ideas like these, see A New Kind of Science (2002) by Stephen Wolfram, Order Out of Chaos (1984) by Ilya Prigogine, and The Origins of Order: Self-Organization and Selection in Evolution (1993) by Stuart Kauffman.
- 15. Beinhocker, channelling Hayek, calls these "Big Man" systems because they are shaped by one central actor and they're slow searchers. He considers them completely unable to cope with the Problem of Possibility in the Library of Smith. See pgs 279-297, 415-450 in Origin of Wealth. See also White Man's Burden (2006) by William Easterly for an application of this idea to international development: planners versus searchers.
- Pg. 30, Constitution of Liberty. "Man learns by the disappointment of expectations."
- 17. Pg. 18, "Competition as a Discovery Procedure" The Quarterly Journal of Austrian Economics Vol. 5, No. 3 (Fall 2002): 9-23.
- 18. Pg 9. Ibid.
- "Economics and Knowledge", Economica IV (1937), pp. 33-54. "The Use of Knowledge in Society" American Economic Review, XXXV, No. 4; September, 1945, pp. 519–30, particularly Section V.
- 20. Arguably this problem runs much deeper: to biological and physical systems too.
- 21. Pg. 37, Constitution of Liberty.
- 22. As in the quote at the beginning of this piece, Hayek saw that social systems face the challenge of rapid adaptation.
- 23. Ibid.
- 24. Pg. 20, Fatal Conceit (1988)
- 25. Pg. 36, Ibid.
- 26. One might have as samples from the Library of Hayek an executive-dominated common law democracy with an authoritarian surveillance state, an Islamic-law oligarchy with bureaucracies like the FDA, or a sci-fi 'futarchy' that uses corrective democracy of land owners with the judgments of artificial intelligence and large statistical analysis in supercomputers to make public policy decisions.





F. A. Hayek and the Reason of Rules

Author:

STEFAN KOLEV

Professor of Economics and Economic Policy, West Saxon University of Applied Sciences Zwickau.

Managing Director of the Wilhelm Röpke Institute, Erfurt, Germany General interest in the "classics" of economic thought has markedly risen over the last years. Smith, Marx, Keynes, Schumpeter, Mises and Hayek are all back from the oblivion they had fallen into before the current crisis. Why is that? A look at the ancient Greek verb $\kappa\rho i\nu\omega$ makes one realise that the very word crisis bears in itself the connotation of making a seminal decision on a crossroad. Looking back at the aforementioned authors appears in this line to be an attempt of the public to revisit the fundamental issues of capitalism. Moreover, citizens and media convey the impression that they are annoyed (or at least bored) by the discourse within the profession of "technical economists", who not only failed in forecasting the crisis, but have above all come up with hardly any genuinely new explanation of what has happened before and during this crisis.

Hayek has especially profited from this new trend, for good and bad. It is not only the Tea Party which made some of his books recent bestsellers. In the colourful scene of civic society institutions on both sides of the Atlantic, his œuvre has reached new popularity, by admirers and by critics alike. Being a young scholar with strong inclinations towards history of economic thought, I am the last person to claim that I have "the definitive" definition of what the Hayekian programme is about. Still, after having spent some years in studying 20th century neoliberalism in comparative terms, I do believe that the current reception of Hayekian ideas bears some grave and even dangerous problems which are to be urgently addressed especially by young scholars engaged in various "camps" within this discourse.

The first "battlefield" is the one of the groups within today's liberalism. Even though one might think that the adherents of Hayek, Mises, Rothbard, Hoppe or Ayn Rand share some basic values and should disagree primarily on details, a look at the institutional settings shows some very deep trenches between these groups. The harsh tone and often uncivilised manner of debating might well be (and often is) rather estranging to young "impartial" economists who could gain the impression that these are not so much scientific communities interested in generating new insights, but rather sect-like conventions which are primarily focused at preserving what they deem "the pure" liberalism of their patron.

When it comes to the specific "battlefield" around Hayekian ideas, the picture becomes even more blur. Hayek (perhaps jointly with Milton Friedman) is the figure in 20th century liberalism which has gained the most public attention, as an economist, as a public intellectual and—last but not least—as a policy consultant, with different degrees of activity vis-à-vis Thatcher, Reagan and Pinochet. Both in the liberal network and in the relationship of liberals towards the general public, Hayek has been attached various labels, ranging from "anarcho-capitalist" to "crypto-fascist", depending on the political leanings of the commentator. In terms of his intellectual heritage, labels like "libertarian", "classical liberal", "neoliberal", "ordoliberal" and the like have been attributed to him, with the attempt to put him into some "shoe-box" where he fits perfectly. Some call him a Social Darwinist, so that he would let the weak die under the bridge, others call him a Social Democrat, so that he would establish a moderate version of the welfare state.



My personal reading of Hayek and of his importance for my generation tries to avoid such terminological chaos as much as possible, all the "isms" and labels being in my eyes obscuring rather than clarifying what his research programme is about. Instead, I propose that we should talk about substantive concepts, not about labels or clichés. My proposal for this essay is to concentrate on the concept of rules and to view Hayek's heritage for today through this lens.

Since its very inception, liberalism has had one focal point in the relationship between liberty and rules. Hume, Smith and Kant spent a significant proportion of their scholarly energy to formulate hypotheses as to what the relationships between liberty and rules might be and how they are to be shaped in a liberal order. For them, liberty is not limitless, and cannot be so; liberty has its limits where the individual sphere of a person becomes tangential to the sphere of another person and both are to continue coexisting peacefully. Rule-of-Law and Rechtsstaat are the respective warrants for this peaceful coexistence to persist. But what do these concepts mean for the economic order? What do they mean for economic reality? In what way can one come to proposals as to how concrete economic policy is to be shaped according to the abstract principles of rule of law and equality before the law?

Hayek is for me not a "classical" liberal, he is "simply" a liberal of his time. Uniquely, he taught at all four primary centres of liberalism in the 20th century, i.e. Vienna, London, Chicago and Freiburg. That is why his œuvre offers a blend of various theoretical, methodological and historical imprints. What we have inherited, is to me a twofold contribution:

- » abstract restatement and reformulation of the importance of rules for a liberal order;
- » concrete deductions for branches of economic policies from the reformulated rules.

In my view the second layer is not of such an importance as the first. Of course it is interesting what Hayek had to say on concrete measures to counter cyclical movements, on how to organise monetary policy or to set up a "limited security" type of a welfare state. But these proposals are

1) tied to the formal institutions of the time he lived in and 2) to the informal institutions of the places he lived in. It is not a coincidence that his concrete proposals, for example on constituting the monetary order, varied widely over the decades of his work. Of course they can provoke our thought about today's respective arrangements. The truly lasting heritage is, however, the first layer: his life-long attempt to show to the public, to his fellow economists and to his fellow liberals that rules are absolutely indispensable for a liberal order to be established and to flourish. Already in 1935 when editing the volume on collectivist economic planning, he claimed that liberal economists should not only criticise socialism and interventionism, but must also say what their "positive programme" is, i.e. to say not only what they oppose but also what they actively stand for. In his "Freedom and the Economic System" essay of 1939 and in *The Road to Serfdom* he distanced himself from "complete" laissez faire in the old sense" and proposed instead to start a search for "the most appropriate permanent framework" for competition, which had been "sadly neglected by economists" over the preceding decades. Correspondence to Chicago economist Henry Simons and Freiburg economist Walter Eucken shows that by 1945 Hayek was starting to formulate such a "positive complement" to his critique of socialism and interventionism, which was to eventually become The Constitution of Liberty.

In the title of this essay, I on purpose allude to the skilful alliteration in the 1985 volume of James M. Buchanan and Geoffrey Brennan. Hayek's restatement of 18th and 19th century liberalism is about the reason of rules and about rule-based government/policies. Numerous Hayek fans adore the "pretence of knowledge" stance and claim that we hardly know anything about shaping reality in a liberal way and constantly warn of "constructivistic rationalism". These Hayekian terms are, however, to be used cautiously. Hayek, even in his latest evolutionist period, stressed that these terms are aimed at social engineers who design entirely new systems of rules; and that of course we can assess the utility of single rules. Also, in his famous "Why I Am Not a Conservative" postscript to *The Constitution of Liberty*, he discarded the blind preservation for no other





reason than the issue being a tradition. Hayek is important to us young liberal scholars today precisely for these two reasons: 1) that we should continue on his challenge to think about the best possible nexus between liberty and rules, and 2) that we should not be dogmatic disciples of our intellectual predecessors, but rather be critical and not shy to deduct new policies from the principles we might share with preceding generations. Indeed, rules are in the end the product of cultural evolution, but a very important part of cultural evolution is the scholarly discourse, also among the youngsters there. Our generation can tackle all challenges of this and of the forthcoming crises if we help fellow economists to re-incorporate rules into their paradigms and if we help fellow liberals to stop bashing rules as being per se incompatible with liberty. Yes, do keep it as simple as possible; but, as Albert Einstein added, not simpler.



Can The Law Rule? The Need to Consolidate Third and Fourth Wave Democracies During Economic Recession

Author:

ESZTER NOVA Ph.D.

Political Economy Fellow
Financial Research Institute
Budapest

Successful democratisation does not end after the first freely held elections and a fire-sale privatisation. It entails an implicit learning process when the principles of a limited, constitutional government and the importance of market economy is internalised by a solid and sizeable middle class.

In his 2005 movie, Manderlay, Danish director Lars von Trier tells a tale of a plantation, where a well-meaning newcomer attempts to effect a transition from slavery to freedom and educate former slaves on the principles of democracy. One of her lessons unwittingly demonstrates the uses and abuses of a majority vote.

In a key scene the community of newly liberated slaves are called to make decisions by the ballot. In the absence of central planning and an arbitrary settler of their disputes (i.e. the slave owner) they face questions of how to use the plantation's resources and how to settle ownership disputes. Our well-meaning outsider proposes to vote on the subject. (Instructively, two gunmen are standing behind her during the entire lesson.) The workers sceptically oblige and decision is eventually reached on issues ranging from economics to justice.

The newly liberated slaves are finally getting the hang of this method so when the clock stops one of them proposes to vote on the exact time. By letting them vote on a matter of fact our heroine unwittingly provides us with a cautionary tale of the limitations of majority vote in decision making. This lapse of principle will, of course, come back to haunt her.

The tale also concerns the role of the liberators. It demonstrates what happens when the democratisers are not as theoretically sound as they should be and act as if transition to freedom would be a mere formality.

At the beginning of a democratic transition it may seem temporarily enough to equate democracy with regularly held elections, but the democratic literacy of the population must not end there. The separation of powers, the subtle importance of checks and balances and the rule of law must also be internalised in order to avert the deterioration of democracy into oversimplified majoritism or 'totalitarian democracy'.

Consolidating freedom is not merely an institutional or economic, but a habitual matter. "The most important change which extensive government control produces is a psychological change... in the character of the people. This is necessarily a slow affair, a process which extends not over a few years but perhaps over one or two generations. The important point is that the political ideals of a people and its attitude toward authority are as much the effect as the cause of the political institutions"—writes Hayek in the preface of the 1956 edition of The Road to Serfdom, but foreign advisors (and their economic support) seldom stay long enough to reverse the process entirely and complete the cultural change, let alone to shepherd the newly established democracy through the first rough patch.

The case is even stronger when it comes to the introduction of the market economy. The facilitation of market must not stop at initiating privatisation and setting up well designed institutions. It must continue into the next recession in the business cycle where





calls for unlimited (i.e. effective) power and economic interventionism will inevitably follow.

Before the democratic transition Western style democracy was strongly associated with economic well-being in the countries of Eastern Europe and people often opted for that welfare rather than freedom when they voted. The wealth of the West was more attractive than the responsibilities that came with economic freedom but the distinction did not seem necessary. Democracy was short for the West and it seemed good enough at the time. The real lesson came in the shape of the first prolonged economic recession.

But the distinction has not been sufficiently made in the West either.

Some may argue that in the countries of Western Europe and Japan democratisation happened in the shape of prolonged American presence and the economic impact of the Marshall plan after the Second World War. Market forces weren't completely left on their own devices and the transition was followed by decades of legal and political fight against extremism on both ends of the political spectrum. This effect, combined with an unprecedented and almost uninterrupted boom phase in the business cycle left these countries with strong and populous middle classes.

"Few relations between social, economic and political phenomena are stronger than that between the level of economic development and the existence of democratic politics", wrote Samuel P. Huntington in 1991 referring to the correlation between the size of the middle class and the possibility of a stable democracy in any given country.

The scarcity of resources always puts people on edge and recession triggers an interventionist sentiment in those most affected, but the degree of their desperation varies according to their original economic strength. Economic mismanagement of the planned economies in the Eastern bloc left these countries with weak and dependent middle classes and the first economic downturn has further decimated their numbers.

Pauperised citizens without financial buffers, who cannot reasonably plan their next month, let alone their children's future, rarely concern themselves with the nuances of the rule of law and the need for limited government. Since demand for economic interventionism will always be met by eager politicians as if by a law of nature, the deterioration of democracy can hardly be avoided at that point.

For scholars of the consolidation of democracy it is common wisdom that a rushed democratisation and privatisation are the original sin and a hotbed for later problems. Regularly held elections may be a convenient symbol of democracy from the viewpoint of totalitarian regimes, but further definition, refinement and education is in order to secure democratic consolidation.

The lapse into oversimplified and voluntaristic majoritism in Eastern Europe (the Ukraine, Belarus, Hungary and Romania) may be a case in point. According to Hayek "[t]erms like "liberalism" or "democracy," "capitalism or "socialism," today no longer stand for coherent systems of ideas." Some scholars found no less than 550 different definitions of democracy (Diamond 1999) in the academic literature of the subject; we can thus safely conclude that for all aims and purposes, democracy is an –ism. A popular shortcut for a state of freedom, but lacking further definition the term is open for abuse and it contains its own demise.

Given that the stability of a democracy closely correlates with the existence of a wide middle class, the treatment of the business cycle determines the survival of constitutional democracy, the rule of law and the separation of powers. This should be a lesson for democratisers of the future.





FINANCE AND BUSINESS CYCLES

A Hayekian Critique of the New Financial Institutions Insolvency Policies

Mathieu Bédard, Ph.D. candidate in economics at Aix-Marseille Université, and Attaché temporaire d'enseignement et de recherche at Toulouse School of Economics.

Hayekian Cure for Financial Crises—The General Principle of Property Rights

Josef Mládek, Ph.D. candidate at University of Economics, Prague and Department of Financial Markets, Czech Ministry of Finance.

Hayek's The Sensory Order, Crises, and Resilience

Wolf von Laer, Ph.D. student, Department for Political Economy at King's College London.





A Hayekian Critique of the New Financial Institutions Insolvency Policies

Author:

MATHIEU BÉDARD

Ph.D. candidate in economics at Aix-Marseille Université, and Attaché temporaire d'enseignement et de recherche at Toulouse School of Economics Banks and other financial institutions' insolvency are increasingly treated differently from other insolvencies. The justifications given for these exceptions involve their sheer size and their failure's negative externalities. The queen of these externalities, systemic risk, is a blanket concept frequently invoked as a reason for these special treatments, and could be summarized as the fear that they could trigger waves of bankruptcies and effectively render the financial system inoperative. It has sometimes been characterized as "Armageddon" by scholars and pundits.

These externalities, whether they are real or imagined, have been dealt with during the recent crisis through various kinds of ad hoc bailouts, at great cost for the taxpayer. Academic debates have since been in search of an alternative to deal with insolvent financial institutions. This essay will review the option that has dominated European debates, and provide a critical reappraisal through a perspective that has been regrettably absent in this discussion, that of the late F. A. Hayek.

The proposition that has attracted the most sympathies in Europe has been the principle of 'bail-in.' At its core, bail-ins are the idea that not only shareholders but also creditors should suffer from insolvency. As a compensation for these haircuts, they would become the new shareholders. While hardly the sole proposition, it has found itself a way into legislation through what could be called "bail-in powers." At the initiation of the insolvency procedures, regulators will forfeit shareholder rights and turn some debt contracts into ownership claims, with the stated goal of not disrupting the insolvent firm's activities. These "bail-in powers" have been enacted into law in the UK and France, and will likely be extended by the coming European Union Recovery and Resolution Directive.

Resolving insolvencies through debt-to-equity swaps is not new, nor is it exclusive to financial institutions. It is loosely based on some 1990s Chapter 11 reform proposals. These plans were thought to be the solution that would emerge if bankruptcy law was dissolved into contractual liberty rather than a solution enforced by, and left to the discretion of, the regulator. Thus, a large body of criticism covering many different types of agency problems already exists in the literature that opposed these "libertarian" procedures. The debate, however, has completely abandoned any contractual innovation and experimentation subtext. As such, despite a similar outline, scholars have raised concerns that are absent in bankruptcy, and would be absent in contract bankruptcy.

The first is the initiation of insolvency, a crucial feature to avoid large losses that are thought to be a source of systemic risk. If resolution procedures are not initiated quickly when the firm becomes insolvent, losses might rapidly escalate. Regulators lack incentives to do this, and might be under political and industry pressure not to initiate procedures upon large financial institutions. The second is a problem of valuation. Bail-ins are a kind of inside sale of the firm to creditors, and regulators are expected to guess the right price without a price system, much like a central planner would do.⁴ Additionally, it is quite possible that the impending threat of swapping bonds for equity will trigger creditor flights to security, creating the firesales systemic risk regulation sought to avoid.



Furthermore, the discussion seems to unquestionably imply that it is always best to keep failed banks as going-concerns, and that liquidation must be avoided at all costs. Not only is it highly improbable that assets deployed in failed banks are always used more efficiently than their next best use, but it exposes bail-in powers to a staunch Hayekian critique. Hayek⁵ contended that law should be "end-independent," and not try to establish a predetermined state of affairs:

Although we can endeavour to improve a spontaneous order by revising the general rules on which it rests, and can supplement its results by the efforts of various organisations, we cannot improve the results by specific commands that deprive its members of the possibility of using their knowledge for their purpose.

Indeed, the central message in Hayek is one of intellectual modesty, emphasizing the limits we face in our analysis and mastery of social phenomena. He emphasized that competition was needed to make a fuller use of society's dispersed knowledge. When free to innovate, and free to accept or reject different opportunities, knowledge that would otherwise be lost is put at the service of other market participants. The most classical example of this is the price system and how it provides results that would be unattainable if economic decisions were centralized, but it is also the case for legal systems where interactions leads to the emergence of law. By extension, the freer we are to use our individual knowledge, the better this process will provide us with institutions that cope with our limited knowledge of the world and our limited rationality.

Another point on which Hayek would have been critical is that, by its nature, 'bail-in powers' require a lot of discretion and arbitrariness. Not every financial institution is a likely candidate for a bail-in, and it has to be used jointly with a variety of other techniques and measures. This large discretion is incompatible with Hayek's vision of the rule of law, in which government "is bound by 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."

While policy has chosen, for better or for worse, the camp of bail-ins, the Hayekian solution to financial institution's insolvency is then to recognize our limitations. The rule of law should be part of this solution, just as it is a prerequisite part of most alternatives. But in this case it is also sufficient. It does not require the rule of law; it is the rule of law. Another clue is to find inspiration in the thought process of Hayek. When he finally came to the realization that he could not know the ideal monetary policy, his approach was to take a step back, and re-frame the debate in terms of a regime of competing currencies. 10 To find a robust solution to our problem we can follow the same thought process, and go to the meta-level by leaving insolvency resolution up to competing voluntary arrangements. Instead of being automatically inside-sold to creditors, the firm would be outside-sold on the market. This could take the shape of an increased place for contract bankruptcy, or open-ended going-concern auctions. Genuine entrepreneurial plans would drive acquisition decisions and result in market prices, and allow for results ranging from liquidation to sale as a going-concern to emerge as a spontaneous order. 11 It would be possible for creditors to become the new owners only if it is more desirable than the alternatives to those with local knowledge.





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Hayekian Cure for Financial Crises—The General Principle of Property Rights

Author:

JOSEF MLÁDEK

Ph.D. candidate at University of Economics, Prague and Department of Financial Markets, Czech Ministry of Finance

Opinions expressed in this essay are strictly the author's own and may not reflect those of his associated organisations. One can only speculate what exactly Hayek would say about the causes and cures of the recent financial crisis. To be the same, Hayek today would have to be somewhat different. Having been responsive to the contemporary developments in the past, Hayek would again come up with novel insights unseen by most of the others. Hayek would also likely join and shape, if not lead, research in the areas of new institutional economics, law and economics and public choice, much of which he himself inspired and initiated. Hayek's engagement in the public debate, and his ability to reflect on ideas of others and his own, influenced his research in the past. As a leading scholar on evolutionary processes Hayek would therefore not merely statically repeat his former statements.

BROADER HAYEKIAN EXPLANATION OF THE FINANCIAL CRISIS

Hayek's analysis of unintended consequences of interest rates manipulation by monetary authorities resulting into business cycle is usually considered to be the Hayekian explanation of the financial crisis.

Indeed the disruption of interest rates, as a key coordinating price signal for conduct of economic calculation, certainly hampered the process of use of knowledge in society and contributed to capital misallocation, resulting into an artificial increase of indebtedness and financial sector losses. However, it is by far not the only Hayekian explanation of the recent crisis.

Hayek's life span prevented him from commenting on the unintended consequences of the centralized and increasingly detailed risk "prudential" regulations that were being implemented since early 1990s in the banking sector and are known as the Basel accords. Regulatory reforms drafted in response to the crisis (such as the Basel accords) may not be "only nervously attacking the symptoms but not the real roots of the problem" (De Soto, 2010), they are probably also an important factor making things much worse, Hayek might have noted. Hayek would surely highlight the recent financial crisis as a crisis of central planning, scientism and an attempt of centralized use of knowledge that are all deeply embedded in this quest for centrally planned artificial stability.

The Hayekian narrative has already been written by the very practitioners seeking and suggesting remedy for the failure of prudential regulation of financial markets.

Dispersed and tacit knowledge on risk in the financial system is inherently difficult to centralise. "[P]ollution of systemic risk created by the financial system is not as easily measured as the [physical quantities of] smokestack pollution created by nonfinancial enterprises" (Krainer, 2012, p. 132). Complex regulatory measures, such as "systemic risk based capital requirements ... may make sense for an omniscient being, they probably do not make sense for regulators operating with the very limited information actually available to them" (Danielsson et. al, 2012, p. 27). Borio (2013, p. 2) counters the argument that just only more data may solve the knowledge problems of centralized prudential regulation as he claims that "not lack of statistics but the failure to interpret them" can cause a crisis of a regulated financial system.





Touching on the Hayek's argument that methods of (natural) science cannot be deployed to study purposeful human action, Danielsson (2008) notes that "finance is not physics" as he comments on the failures of modelling in financial markets. Landau (2009, p. 2) regards the nature of the financial system that is "truly unpredictable and uncertain, in the Knightian sense" to be the reason for a "spectacular failure of models during the crisis". Furthermore, dealing with complexity is "more difficult when human behaviour is directly involved" (ibid., p.4).

Others warn against the fatal conceit that a centralized fully automatic risk regulation system can ever be designed. "Macroprudential settings do not run solely on autopilot" (Caruana, 2010, p. 5). Implementation of macroprudential policy will have to make "difficult and potentially costly judgment calls, relying on imperfect real-time information" (Yellen, 2011, p. 11). "One of the greatest dangers is to think that we have finally come to master the secrets of the economy, for these are a moving target" (Borio, 2006, p. 22).

HAYEKIAN CONSTRAINTS OF A HAYEKIAN REFORM

Some support decentralized regulation of bank risk taking by self-interested agents—investors, i.e. market discipline, explicitly (Hetzel, 2009, p. 166), others (probably) merely indirectly imply it. Given the "complex and specialized" nature of the task, Hüpkes et al. (2005, p. 19) conclude that regulation and supervision can only be "held accountable by a combination of instruments and arrangements" employing "complementary and overlapping checking mechanisms." Landau (2009, p. 3) calls for "a permanent reexamination of structure [of the complex dynamics of the financial system] and constantly testing it against very adverse circumstances."

However, implementing the rules of market discipline into a regulatory discipline framework without the original, local, incentives that facilitated the Kirznerian entrepreneurial discovery process of these rules, runs the risk of "ossifying, as well as weakening, and even corrupting the efficacy of

the private sector institutions and techniques that have been assimilated [into public regulatory framework]" (Macey, 2013, p. 591).

Acemoglu and Robinson (2013, p. 21) notice that "[e]conomic reforms implemented without an understanding of their political consequences, rather than promoting economic efficiency, can significantly reduce it." Hayek would probably add that due to the complexity of the financial system the lack of understanding of the political and other consequences can hardly ever be fully overcome.

This does not at all imply that reforms aimed at limiting special interest and promoting free markets in the financial sector should not be strived for. However, even a free market reform is an exercise in central planning. After picking the low hanging fruits of the most straightforward and obvious errors of the regulatory status quo, the scope for reform measures that can be undertaken without a risk of unintended secondary effects can be rather limited.

Seeking social justice by mitigating rent seeking can have its unintended consequences. By successfully limiting the power of some special interest groups, a reform can unintentionally disrupt the complex structure of checks and balances among the ecosystem of special interest groups that prevents them from even greater predation. Dispersed groups (e.g. consumers) that are potentially vulnerable to rent seeking may in fact be somewhat protected by rivalries among the special interest groups. For example, Krozsner and Strahan (2001, p. 237) suggest that intra-industry and interindustry rivalry "can increase the likelihood of beneficial reform. Rival groups have an incentive to battle each other in addition to battling the consumer. If they dissipate their efforts against each other, they are less likely to be able to support narrow special interest regulation."

The ultimate question therefore is what would Hayek support as a robust policy recommendation?

If consequences of even a benevolent reform are uncertain, nudging the market in the "right" direction can be disastrous. In the world of Hayekian evolution there is no specific and static rule or safeguard to discipline other agents and prevent them



from rent seeking. Discipline, justice and prosperity can only be achieved as an unintended result of dynamic processes.

Rather than suggesting a specific objective to follow, Hayek would therefore probably recommend merely a general principle of property rights that can prevent conflict and support sound economic calculation and thereby facilitate peace and prosperity in society. In addition, a more widespread understanding of the benefits of property rights may guide the process of a pro-market reform and keep it on track. Promoting this general principle is probably the most robust and truly a Hayekian response to at least mitigate the risk of future financial crises.

What our generation has forgotten is that the system of private property is the most important guarantee of freedom, not only for those who own property, but scarcely less for those who do not. It is only because the control of the means of production is divided among many people acting independently that nobody has complete power over us, that we as individuals can decide what to do with ourselves.

(Hayek, Road to Serfdom, 1944, p. 115)





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Hayek's The Sensory Order, Crises, and Resilience

INTRODUCTION

Author:

WOLF VON LAER

Ph.D. student, Department for Political Economy at King's College London

The author wishes to express his gratitude to Austen Given and David Skarbek for useful hints and suggestions for improvement. Opinions expressed in this essay are strictly of the authors own and may not reflect those of his associated organisations.

Friedrich Hayek argues in his work consistently for institutions that constrain government, enable the flow information to overcome the knowledge problem, and takes seriously the limitations of human capabilities to shape society in a rationalistic constructed way. One of Hayek's most sophisticated scholarly works that is often neglected in academic and policy discourse is *The Sensory Order* (Butos and Koppl 1993, 307, Fn 4). In this book Hayek elaborated ideas he had as a young student about the topic of theoretical psychology. *The Sensory Order* is crucial for understanding the cognitive foundations of Hayek's work in the realm of legal philosophy, economics, and political theory.

In this essay, I argue that *The Sensory Order* is not only crucial to understand Hayek's vision of a liberal order as Caldwell (2008, 275–277) and Horwitz (2000) have shown, but more specifically that one can derive useful policy conclusions from the book to increase the resilience of public institutions during crisis.

THE IMPORTANCE OF CRISES AND THE LACK OF ECONOMIC THEORIES OF DECISION-MAKING

Economic crises are events that affect a significant amount of economic actors negatively. Wars and economic crises are periods of government growth; the displacement and ratchet-effect theory show that government tends to expand rapidly and persistently during and after crises (Peacock and Wiseman 1961; Higgs 1987). Economics has many theories to offer about how and when crises occur and ought to be done about them. However, our knowledge of the actual processes of decision-making during crises and the prerequisites for policy makers to respond adequately are widely unexplored. Hayek's work in theoretical psychology reveals deep epistemic problems with crisis politics.

THE SENSORY ORDER

Hayek published *The Sensory Order* in 1952. The book is different than the rest of his work. It did not have a large readership when it was published; nevertheless it anticipated findings in cognitive neuroscience by several decades (Fuster 2011; Weimer 2011). The insights gained from *The Sensory Order* are still relevant and highly significant for the improvement of institutions today. Before I outline the crisis management conclusion derived from *The Sensory Order*; the main arguments of the book have to be briefly summarized.

In *The Sensory Order* Hayek argues that sense stimuli are not objectively interpreted. Stimuli are filtered through our sensory order, our mental map, which is based on prior experiences. Our mind works as a classification device. Every event is interpreted within a causal relationship; if A happens, B follows. If a given interpretation of a stimulus is not conducive for the individual to form a course of action that corresponds with the external environment, then a mistake has





been made and a reclassification of the stimulus will take place. Hence the brain developed and develops through a trial and error process. This process helps the individual to learn from her mistakes and to classify sense data in a way that makes the external environment intelligible and life possible. This cognitive operation happens continuously to form a "semi-permanent" cognitive structure (Hayek 1976a, 16, 42–53; Caldwell 2008, 261–270). Several insights can be drawn from Hayek's book with relevance to the questions at hand regarding crisis management.

THE SENSORY ORDER, CRISIS MANAGEMENT, AND RESILIENCE

- Our mind as a classification scheme works in a causal framework. During crises, the mind has to reclassify many aspects of the external environment to adapt itself to the new set of circumstances. However, individual efforts to improve their situations after a crisis can be impaired by inconsistent, piecemeal, and volatile government interference in the market. Piecemeal interventions and public institutions working cross-purposes are common in crises (Boin et al. 2005, 12, 22; Birkland et al. 2009, 34). This can lead to an additional level of uncertainty induced through policy. The process of adaption might be delayed if changes in the 'rules of the game' make the individual's causal framework even more complex and volatile. Hayek's insights into the mind provide an epistemological argument for how policy uncertainty can lead to a sluggish recovery (Higgs 1997; Baker, Bloom, and Davis 2012; Laer and Martin 2013).
- 2. Furthermore, Hayek shows that human beings are dependent on and to some degree caught by past experiences (Hayek 1976a, 107–110). Breaking away from past experiences and to think in different terms about a problem is not what the mind readily does. This phenomenon is even more pronounced within public sector institutions, as Pierson (2004, 30–45) shows. Stress, a key aspect of crises, even further strengthens this bias towards old-behaviour patterns (Boin et al.

- 2005, 30). Jones (2001, 4) also seems to confirm Hayek's argument and finds that public sector institutions exhibit path-dependent behaviour due to epistemological and ideological reasons. From this follows that crisis policies will not likely be fundamentally different from past crisis policies. However, each historical crisis is unique and is likely to require different solutions. Potentially static minds and public institutions could be antithetical to find proper remedies for a crisis.
- 3. The most important argument derived from *The Sensory* Order concerns the knowledge problem. The knowledge problem in crises is not only about the economic impossibility of communicating the circumstances of time and place to the agency developing a response policy. It is also about the impossibility of communicating past experience and the adapted cognitive framework of the individual to the policy maker. Hayek argues that our mind adapts to our environment. If we have trust in this process to make life intelligible then it follows that the person with the cognitive framework adapted to the circumstances of time and place is better prepared to make decisions than the policy maker detached from these circumstances. The knowledge about one's business, product, and market has been shaped by countless processes of trial and error. Even if we assume that the policy maker grasped the circumstances of time and place better than the individual on the ground, the policy maker cannot fully appreciate this information, since full comprehension depends on the tacit knowledge developed through acting in the business environment (Hayek 1976a, 110). The policy maker has no means to address the specific situational problem faced by the economic agent on the ground since his mental map is shaped by different experiences. This cognitive neuroscientific insight adds an additional explanatory layer to the knowledge problem and makes it even more significant.

Resilience means that institutions should not be impaired by exogenous shocks like crises. Institutions can bend but are not supposed to break from external pressure (Birkland et al. 2009, 17). Functioning institutions are possible within crises



but their actions have to be limited to actions that sustain their functioning. Hayek's insights reveal that decision-makers in crisis are cognitively ill-prepared for the microeconomic changes necessary to overcome a crisis. The macroeconomic aggregated world view of most policy makers in economic crises cannot classify and thus conceptualize the millions of individual micro-adjustments that are necessary for an ever-changing and adapting economy. The trial and error process is both important for the mind and for the economic process (Hayek 1968). Only if mistakes have been fully revealed in a crisis can the agents take in new information, build new classifications, and improve upon the situation. There will be millions of different micro-solutions necessary to solve an overall crisis situation. If the situation is obfuscated by governmental interference in economic decision-making, this learning and improvement process is likely to take place at a slower pace. Learning, a key aspect in Hayek's research, is thwarted (Hayek 1976a, xx–xxi, 169–170).

CONCLUSION

"We are ready to accept almost any explanation of the present crisis of our civilization except one: that the present state of the world may be the result of genuine error on our own part and that the pursuit of some of our most cherished ideals has apparently produced results utterly different from those which we expected," writes Hayek (1976b, 65–66). This insight is applicable to the sluggish recovery most Western nations experience now. *The Sensory Order* contributes to an understanding of why economic crisis policies have been insufficient. The complexity of the social system overwhelms our cognitive capabilities (Hayek 1976a, 39, 184–190; Hayek 1962). *The Sensory Order*, and Hayek's overall research program reveal that our limitations of knowledge are more severe than we would like to admit. Hayek's work demonstrates that humility ought to be the default position when it comes to crisis policies affecting millions of human beings. The only sensible crisis response policy is one that provides general rules in which agents can make decisions for themselves depending on their own sensory order, and unique to their own circumstances of time and place.





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'WICKED PROBLEMS'

What Would Hayek Say About Gendered Violence?

Nick Cowen, Kings College London.

Hayek and the 'Wicked Problem' or, When Welfare is Necessary

Helen Dale LLB, MBM Commercial.

Abolition as a Positive Program: A Hayekian Perspective on Intellectual Property

Adam Martin, Department of Political Economy, King's College London.





What Would Hayek Say About Gendered Violence?*

Author:

NICK COWEN

Kings College London

Violence and discrimination against women and sexual minorities are significant public policy problems. At the most extreme end of the spectrum, male perpetrated homicide of a female partner is one of the most common types of murder. In every day experience, many women report threatening comments, groping and other non-consensual touching; as well as discrimination in the workplace. Similar, sometimes more acute, experiences are reported by visible sexual minorities, including those who are openly gay and lesbian, and especially transgendered individuals.

These groups do not always share social and political interests. Traditional feminists accuse men of demeaning women, while themselves disavowing transexuals as 'men in drag', frequently excluding them from their groups. Social media has revealed how male 'trolls' frequently abuse women who advance feminist interests.² Ironically, some feminists, in turn, abuse queer activists when a doctrinal disagreement emerges.³ Feminists then feel silenced by 'queer' activists who derail attempts to advance women's interests.⁴ The result is that the politics of gender and sexuality sometimes resemble a Mexican stand-off with multiple parties claiming grievances against one another with little hope of reconciling these different interests. Like the socialist planners coming to blows over the specifics of their plans, these different interests agree that the state must intervene somehow but disagree over the character of that intervention.⁵ Hayek's theories can help diagnose the problem of imposing particular sex and gender categories on a political community, and tentatively suggest some solutions to gendered violence.

Judith Butler explained the feminists' conundrum.⁶ She argues that there is no universal normative idea of sex. One cannot find a natural sexuality that is divorced from political power since even repressed sexualities are formed as distinct identities using the same forces that oppress them. It is heterosexuality that creates the homosexuality one sees practised and desired. In fact, 'sex' as an institution is generated by social practice, a set of acts that are grouped together using various ethical, medical and juridical discourses.

This 'troubles' some feminists as it means that their primary category of political representation (women) is constituted by the very forces of domination that their theories attempt to reform. But, of course, it should trouble anyone who cares about human freedom since according to Butler, sexuality and gender are in no sense natural facts, but unchosen institutional impositions. They even generate our individual identities and create, police and punish transgressions against them.

Butler's references to classical liberalism are quite basic, treating it essentially as an ideological adherence to contract as legitimating power. She does not discuss classical liberal social theory at all. This is unfortunate as Butler seeks out a concept that breaks down the binaries of natural facts and social constructs, and free will and determinism. She notes that although always acting within a set of boundaries defined by social institutions, freedom can be found through elaboration on or even parodying of existing practices. Hence, she emphasises the role of queer sexuality in opening up new possibilities in human discourse. Such a concept, of a contingent social framework that structures individual will and identity is very close to the notion of spontaneous orders in Hayek's social theory.⁷



Spontaneous orders, for Hayek, are emergent institutions that are the product of human action but not of human design. Like natural rock formations that are formed over millions of years, they look so elaborate that one assumes they are a product of intelligence. In fact, they are hewn over generations of human interaction not according to a single plan or design. Institutions like language, law and property fall under this category. For example, there is no author of the English language, but a designer of a means of verbal communication could hardly have come up with a better system (Esperanto, a 'rationally' constructed language, never took off). People come to be defined and identified by many of these orders, whether as English speakers or as subjects of common law, and this is prior to the deliberate decisions of individuals or Governments, which have to contend with what a post-structuralist might call the 'always already' present aspect of these institutions.

Hayek offers an important distinction between concrete orders (physical objects being the paradigm) that always have more to be discovered than has been perceived by humans, and abstract orders, the only sort of orders that are fully comprehensible to humans.8 On my account, human bodies are the concrete orders that the abstractions of gender and sexuality attempt to comprehend. This distinction explains how visible displays of homosexuality, or tranvestism, or simply women taking leadership roles, can be seen as provocative and even prompt violence. In each case, a social order is being disrupted. Something simple and concrete, like a man kissing another man, disturbs because it fails to fit the abstract order of norms on which many people want to rely. On my Hayekian account, these disruptions are necessary and should be embraced. Fixing sexual norms using state power is as ill-advised as trying to freeze the English language permanently in law.

It's understandable that heterosexuality flourished as a norm when reproductive capacity was scarce. Now, however, heterosexual norms can operate like a trade union's closed shop, legitimating only some kinds of sexual interaction and sometimes violently suppressing innovations in human relations. Some people benefit from this asymmetrical enforcement of sexual norms, while others find themselves excluded. In addition, the policing of sexuality has led (as with

most prohibitions) to unintended consequences, the creation of alternative identities like homosexuality (which was originally a psychiatric concept). This is a parallel idea to Butler's suggestion that juridical prohibitions help to generate the very subversive sexual desires they avowedly attempt to suppress.

SEXUALITY IN A HAYEKIAN POLYCENTRIC ORDER

Many who oppose gender violence emphasise media campaigns and legislation, especially anti-discrimination laws, to protect sexual minorities and women. The problem is that this approach weighs heavily on the supposedly liberating power of verbal argument to change people's preferences. When public discussion fails to produce the right outcome, many feminists and progressives resort to censorship to 'improve' the process of public deliberation. The reaction of classical liberals to these problems is sometimes a little muted, limited to the demand for formal equality.

Hayek offers more positive solutions, emphasising the communicative power of the market place. ⁹ Just as private property allows individuals and groups to experiment with different ways of producing goods and services, it also allows for experiments in living—to see what kind of intimate social orders are successful and sustainable. This reduces the zerosum aspect of social difference. A public 'conversation' followed by legislation on what sexual identities will be recognised means that one side has 'lost' the public debate and had their preferences negated. A polycentric order allows different preferences to be promoted in different environments.

Feminists have argued for the importance of 'safe spaces' in which women are pointedly able to exclude men. Such spaces are made possible only through respect for property in a polycentric order. Tom Palmer points out how growing respect for private property in China was a driver of liberalisation of homosexuality. Sexual minorities can now congregate freely in private bars and form their own households. While progressives fault the discriminatory exclusion of minorities from clubs and societies, they miss out on the liberating powers of minorities to engage in exclusively private action too.





Immediately, the right to associate or disassociate promotes personal security and privacy. In the longer term, strong private associations allow minorities to square up to those that oppress them. The state has a role: protecting individuals, no matter how eccentric or different from the norm, from physical violence. But it steps back from challenging social norms. That's left to the spontaneous actions of individuals and groups. Aggression towards women and sexual minorities is often diffuse and unplanned. Part of the response to it has to be similarly grounded in everyday practices rather than state policies.

Social change in Hayek's spontaneous order is characterised by piecemeal adaptation rather than statutory reform. By following their personal plans, individuals have an imperceptible but decisive role shaping their future social world. In any existing social order, many people are satisfied with following a set of sex and gender norms in the same way that most people are happy to pick out a style of clothes that suits them (and in a sense comes to define them), rather than making their clothes from scratch.

Polycentric orders offer choice: whether identifying as straight, gay, male, female or anything else. In this context, 'queer' individuals take the role of social entrepreneurs, combining ways of living in new ways. The more successful or aesthetically-engaging lifestyles are further developed by others. Popular identities remain common but are not enforced through violence or legislation. Alternatives to existing sexualities are allowed to flourish. People are not bound by one abstract order, statutorily enforced, but are allowed to develop new orders that use and display our personalities in different ways.

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Hayek and the 'Wicked Problem' or, When Welfare is Necessary

THE BABY FARM

Author:

HELEN DALE

MBM Commercial

In 1892, 18 year-old Amber Murray placed an advertisement in the *Sydney Morning Herald* for "a kind person to take charge" of her baby son, Horace. Horace was illegitimate, and Amber had spent three months unable to juggle work and baby.

The advertisement drew the attention of John and Sarah Makin. They seemed kindly, and in return for an upfront payment of £3 and ongoing payments of 10s a week, offered to care for Horace while still allowing Amber to visit him. Over the following weeks and months, Amber kept trying to see Horace, only to be rebuffed with excuses. Eventually, she arrived to find that the Makins had disappeared.

In October of the same year, council worker James Hanoney was clearing a blocked drain when he discovered the bodies of two infants. The Makins had moved again, but by now the resources of the New South Wales police were directed to investigating every house in which they had ever lived. The police found 12 dead bodies in addition to Horace's, which Amber identified from his clothing.

The Makins were "baby farmers", a descriptor of sufficient vintage to be foreign to most people now. Baby farmers relied on the stigma of illegitimacy and laws that mandated that men did not have to provide for children born out of wedlock to take in infants and, very frequently, kill them. Because the sums of money the single women provided were of necessity small, it was better for the baby farmer to kill the child swiftly: that was more profitable.

The Makin case—a true cause célèbre—made its way to the House of Lords.¹ Trial evidence disclosed that the Makins turned to baby farming after John, a brewery drayman, had been injured at work. Meanwhile, Sarah had once been a midwife, and was not unkind: indeed, when the court imposed sentence, her daughters pleaded for clemency and her capital conviction was commuted to life imprisonment. John, however, was hanged in 1893.

Laws were changed in Makin's wake: the NSW parliament enacted the *Children's Protection Act 1892*, which brought the care of orphaned and destitute children under state or church control. At the same time, a shift towards providing welfare support to single mothers commenced, although the latter did not emerge as the preferred policy until it became clear that institutional care had also failed: in Australia, the failure was spectacular, and the hammer blows fell particularly hard on the country's mixed race population: children born of an Aboriginal mother and a white or Asian father. There, children taken into care not only often died, but when they lived were treated with disdain.²

Of course, this is not to pretend that the care institutions in other countries that now go by the name 'developed' were much better: to assay the widespread abuse, sexual and otherwise, in orphanages, care homes, and facilities directed at unmarried mothers³ is merely to state the commonplaces of recent times.





THE NECESSITY OF HAYEK

Providing adequate care for unwanted children and the women who bear them is a wicked problem, incapable of complete solution. We can improve it, but fixing it is out of the question. Wicked problems are difficult or impossible to solve, typically, for four reasons⁴: here, we confront incomplete or contradictory knowledge (why do women have children?); a vast number of people and opinions involved (every unmarried mother, those who set welfare policy, children raised in single parent households); a large economic burden (welfare is expensive), and the interconnected nature of this problem with other problems (demographic decline is as serious in non-welfare-state filial piety cultures with their 'bare branches' as it is in the pension-crisis afflicted West).

Much ink has been spilt, over many years, criticizing the effect of the welfare state on family structure, starting with Daniel Patrick Moynihan and showing no signs of abatement.⁵ It has focused on diminished outcomes for children and economic disadvantage for their mothers. Some of those criticisms may be true, but they are all flawed because they fail to take account of what came before.

Hayek's support for a limited social safety net is the only means left to us to improve this wicked problem, for two reasons: (1) all previous interventions, save one, have failed; and (2) those interventions, when they failed, did so irrespective of whether they were public or private. This is not a problem where one can make conventional classical liberal arguments about superior private or charitable provision.

THE INTERVENTION THAT WORKED

Before welfare, before orphanages, and before baby-farming there was infanticide, pervasive and on a staggering scale, in every human society of which we have record. The most eminent minds—Plato and Aristotle, Cicero and Ulpian—argued for its necessity. And when eminent minds—Augustine and Aquinas, say—argued against it, not a whit of difference was made to the infant kill rate. About 25% of all children born throughout the Medieval period in Europe were killed—a

higher rate than that in infanticide-approving Rome, in part because the latter was for much of its history more peaceful and prosperous, and perhaps also because its abortionists were more skilled.⁷ As late as 1862, Metropolitan Police reports noted that officers "seemed to think no more of finding a dead child than they did of finding a dead cat or a dead dog".⁸

An echo of humanity's infanticidal past is still found in jury rooms throughout the common law world: the reason we do not refer to infant-killing as "murder" is because in 1922, it was reclassified and re-named with passage of the *Infanticide Act*. This was done because juries refused to convict—even before 1920, when they were all male and the Crown case was overwhelming—and had been refusing to convict for some time. The only crime for which fewer convictions were recorded was abortion. In Scotland, there hadn't been a successful abortion prosecution for 50 years. ⁹ To this day, infanticide convictions are astonishingly rare. ¹⁰

However, as what would become the developed world transitioned from infanticide to the baby farm to the orphanage to the welfare state, it not only became richer, but it developed reliable contraception and legalized or decriminalized abortion. Infanticide rates collapsed: the crime became a legal curiosity.¹¹

To that extent, then, this wicked problem was ameliorated even if it was not solved. The interventions of science and medicine succeeded. All the other interventions directed at preventing infanticide or improving morality or lessening promiscuity or caring for unmarried mothers and their babies or however else the wicked problem was conceptualised failed badly. We still live with the daily aftershocks of that failure, as lawsuits by the living are brought against the institutions that abused them, exploited their labour, stole their children away, etc.

EQUAL FAILURES

Worse, both the public and private sectors manifested the failures in remarkably equal proportions. Churches, local authorities, central government care homes, private orphanages, charitable foundations. Classical liberals often



argue with some force and considerable evidence that things provided by the state would be better provided by the private or charitable sector: there is no persuasive reason why the state should run an airline, for example, or a telecommunications company, or any number of (un)natural monopolies. That argument does not hold here: maybe we human primates are just bad at institutional care.

However, when we consider Hayek's argument for "a limited security which can be achieved for all", 12 then the welfare state in combination with contraception and abortion has done most to vitiate the wicked problem of the enormous disadvantage heaped on women simply by virtue of the fact that they give birth. 13 Of course, this is not to pretend that the welfare state is without flaws, but rather—at least in this narrow field—that it is like democracy: the worst system of the lot, except for all the others we've tried. Yes, it is fair to say that the welfare state produced Baby P14 (the closest to the cruelties of Makin, say, or the *patria potestas* of Rome's Twelve Tables) and Karen Matthews. 15 It is also fair to suggest that cutting generous benefits may drive the abortion rate up. Attempts to make abortion illegal or to restrict access to it would, however, have worse effects. The abortion rate in periods of illegality does not decline; the procedure simply becomes unsafe. Infanticide may also re-emerge, along with its recalcitrant juries.

Further, the British public has also shown itself quite adept at doing utilitarian calculus, and those socially conservative people who wish to cut welfare to single mothers may find themselves confronted by a public happy to pay for abortions instead: abortions are cheap, adequate child welfare services are not.

We now know that it is impossible for even a highly productive market economy to provide "assurance of a given standard of life, which is determined by comparing the standard enjoyed by a person or group with that of others". 16 Britain's escalating pensions crisis is ample evidence of that. However, attempts to do away with welfare may expose us to wickedness that many of us have forgotten ever existed, something Hayek saw far more clearly than many people who purport to endorse his ideas:

There is no reason why in a free society government should not assure to all protection against severe deprivation in the form of an assured minimum income, or a floor below which nobody need descend. To enter into such an insurance against extreme misfortune may well be in the interest of all.¹⁷

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Abolition as a Positive Program: A Hayekian Perspective on Intellectual Property

Author:

ADAM MARTIN

Department of Political Economy, King's College London F.A. Hayek argues that—owing to the interdependence of individual plans in a world of scarcity, the necessarily dispersed knowledge of human wants and how best to satisfy them, and the omnipresence of unforeseeable changes in economic conditions—the only way to reliably improve on spontaneously generated market outcomes is to abstain from direct intervention and instead modify the rules that shape those outcomes. Intellectual property law seems like the type of legislation that would fit well within this rule-centric policy paradigm. Nonetheless, Hayek (1988, pp. 36-7)—albeit briefly—expresses serious reservations about intellectual property (IP). In this essay I argue that a Hayekian understanding of market processes offers two weighty reasons for taking a generally abolitionist stance toward existing IP law.

COMPETITION AS A (PERVERSE) DISCOVERY PROCEDURE

Debates over IP usually centre on two countervailing effects it has on the costs and benefits of innovation. On one hand, IP allows innovators to reap higher returns on their ideas, eliciting larger R&D investments across a wider range of industries (Moser 2005). On the other hand, where innovation is cumulative, IP makes subsequent improvements on those initial ideas more costly (Boldrin and Levine 2013). Ascertaining the effects of IP on innovation and thus on social welfare requires weighing the relative magnitudes of these two effects.

Hayek's understanding of competition as a discovery procedure differs in subtle and important ways from more mechanical theories of production and investment (c.f. Hayek 1968). Capitalist production is not a simple functional relationship between quantities of given inputs and outputs, but a structural problem of aligning heterogeneous goods into capital combinations that satisfy desires at a low opportunity cost. If this is true of the production in general it is doubly relevant when discussing innovation. "The mind cannot foresee its own advance" (Hayek 1960, p. 24). Discovering new and efficient production methods is a matter of imagination, serendipity, and context as much or more as investments into research and development. Hayek's approach thus complements the abolitionist argument stressing cumulative innovation.

Competition is valuable for Hayek precisely because we cannot foresee the what, how, and by whom of entrepreneurial discovery. Entrepreneurs respond to market signals and incentives in myriad and unexpected ways. Competition serves to try out these experiments and shut down the failures. The rules that govern economic activity determine what counts as a success or a failure in this competitive process. Entrepreneurs may discover not only productive profit opportunities but also opportunities for rent-seeking activity that transfers wealth rather than creating it. Buchanan (1980) notes that rent-seeking and profit-seeking are the same type of individual behaviour channeled by different rules. So getting the rules right is vital.

'Patent trolling' can be understood as a perverse discovery procedure unleashed by IP law. Chien (2012, 2013) identifies a class of IP litigants as 'Patent-Asserting Entities' (PAE's), who secure revenue not through selling goods or services utilizing IP, but rather through licensing fees and from litigation against IP infringement. This latter revenue stream has become increasingly important in the United States in recent years, in which the number of suits brought by such



entities has increased by over 20% per year (PatentFreedom 2013). PAE's initiated 62% of patent litigation in 2012, making it clear that many of these firms acquire patents solely for the purpose of pursuing litigation. The rise of this strategy follows the US Court of Appeals for the Federal Circuit's widening of patent law to include abstract ideas (e.g., "1-Click Purchase" or "Swipe to Unlock") rather than limiting software patents to actual lines of code (Dourado and Tabarrok 2013).

Patent trolling acts as an unpredictable tax on other economic activity. And while popular perception often associates patent trolling with large, highly visible tech firms, Chien (2012) reports that small enterprises and start-ups are increasingly targeted as well. In 2012 over half of unique PAE defendants were small businesses, and over half were not tech firms (Chien 2013). Insofar as small firms and start-ups are a chief source of the sort of disruptive innovation that generates large gains (c.f. Baumol 2002), the potential costs of such activity are quite large and probably understated in the standard literature.

TWO INVISIBLE HANDS

Hayek's own reservations about IP are expressed not in the context of a discussion about competition and discovery, as might be expected. Rather, they appear in the midst of his discussion of the evolution of property rights (Hayek 1988, Ch. 2). Parallel to the spontaneous character of the market process is the spontaneous development of market institutions. The reciprocal relationship between these two processes drives Hayek's theory of social evolution, with more effective systems of rules outcompeting less effective systems if the state refrains from subverting those rules for the benefit of narrow interests. The context of Hayek's discussion highlights another hidden cost of IP: it crowds out experimentation in the rules governing the use and transmission of non-material goods. Good rules, like good products, need to be discovered through a process of trial and error. The current IP regime, predicated on statutory law, leaves little room for such experimentation.

Benson (2010) aptly characterizes this two-level process: "it takes two invisible hands to make a market," one to establish the rules and one to coordinate economic activity within the rules. When market institutions are given sufficient space to grow from the bottom up, contracting serves as a mechanism for explicit coordination. Experiments with different types of contracts and enforcement mechanisms eventually generates a set of abstract rules that work well to mitigate conflict and enhance the coordination of economic activity in light of dispersed knowledge and divergent expectations. The rules that develop embody the iterated social learning of the preceding contracts. When conditions change such that those rules no longer reflect technological realities, the increased number of disputes sends a clear signal to revise the rules.

Rights are solutions to problems when they grow out of procedures to settle disputes among practitioners in a given domain. When enacted by statue, rights are solutions in search of problems that tend to generate rather than settle disputes. Current IP law did not grow out of this process of experimenting with contractual arrangements, and thus lacks the embodied wisdom of rules developed from practice. That litigation in the current IP regime is driven by non-practitioners is troubling; IP lawyers are exactly the sort of narrow interest that have stifled the invisible hand of legal evolution before.

Innovative contracting is most visible precisely where existing IP law is least enforceable. The market for popular media such as movies, television shows, and music is global. This market probably confronts the highest frequency of IP infringement just because the number of users of that content is vast. But media content delivery has begun to evolve, offering access to large bundles of easily searchable content for very low prices: think Netflix, Pandora, etc. In terms of governance, content piracy produces positive spillover effects by compelling content providers to innovate low cost methods of content delivery (for non-pirates) that generate revenue. At some price, the monetary cost of these bundles is lower than the time cost of searching for pirated content.

The real gains from information technology will only be unleashed when contracting over IP used in production





displays this sort of ingenuity. But current IP law generates institutional sclerosis in precisely the sector of a modern economy in which it is most important to adapt to changing technological conditions. In one sense, the Hayekian case for abolition is that we have had too little IP rather than too much. This is why I have not distinguished between patents and copyrights. Even if we know incentives matter for innovation we cannot know a priori the best way to create them. No one can describe the optimal IP regime, but the default assumption should be that we want more rather than fewer experiments in governance. Or, as Hayek puts it (albeit in a different context):

I have no doubt that the functioning of the market can still be improved by improving the framework of those rules of law within which it operates... It appears to me that at the present time priority must be given to removing the obstacles which, because of lack of understanding of the function of the market, governments have erected or are allowing private agencies to erect. We owe it to the folly of our predecessors that this negative task has become more urgent than positive ones have. Once we have again cleared the road for the more powerful spontaneous forces, we shall be able to return to the slower and more delicate efforts of improving the framework within which the market will function more effectively and beneficially. (Hayek 1981, p. 343-4)

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 Chien's classification of PAE's differs from the more common classification of 'Non-Practicing Entities' in that she distinguishes between those who assert patent rights in pursuit of monetary profits as opposed to research institutions and the like.

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HEALTHCARE AND EDUCATION

A Hayekian System of Health Insurance

Will Duffield, London School of Economics.

On the Use of Knowledge in the U.S. Health Care System

Marta Podemska Mikluch, Beloit College.

Hayek on Education: Designing Markets for Spontaneous Orders

Gabriel H. Sahlgren, London School of Economics.





A Hayekian System of Health Insurance

Author:

WILL DUFFIELD

London School of Economics

Throughout the recent American debate surrounding the *Affordable Care Act*, politicians and political theorists on both sides of the argument have fallen over one another in their attempts to tie great thinkers of the past to their respective arguments. Quotes from Marx, Keynes, even the founders of the American state have been ignominiously hauled into the fray. Hayek has been no stranger to this treatment, being invoked by parties on either side of the debate. Particular attention has been paid to his allowance for some form of social safety net, with those on the left arguing that it amounts to a tacit approval of the *Affordable Care Act*. Politicos opposed to the *Affordable Care Act* have been quick to respond by citing Hayek's work showing the unworkability of centrally planned solutions to social problems that distort the price system, and their tendency to bring about increasingly authoritarian outcomes, the central thrust of "*The Road to Serfdom*". However, these objectors have done little to actually engage Hayek's acceptance of some level of social welfare, particularly in the realm of healthcare. Despite these frequent, if shallow, invocations, little attempt has been made to imagine what a Hayekian system of state health insurance might look like.

Most seized upon has been Hayek's mention of a social safety net in "The Road to Serfdom". In it, Hayek advocates for a redistributive system able to provide for the sorts of disasters that the individual cannot possibly plan for, in effect linking catastrophic medical issues with earthquakes or other acts of god. However, Hayek argues that the safety net must not provide this insurance in fashion that might weaken the incentives individuals have to avoid such disasters.

Nor is there any reason why the state should not assist the individual in providing for those common hazards of life against which, because of their uncertainty, few individuals can make adequate provision. Where, as in the case of sickness and accident, neither the desire to avoid such calamities nor the efforts to overcome their consequences are as a rule weakened by the provision of assistance, where, in short, we deal with genuinely insurable risks, the case for the state's helping to organize a comprehensive system of social insurance is very strong. There are many points of detail where those wishing to preserve the competitive system and those wishing to super-cede it by something different will disagree on the details of such schemes; and it is possible under the name of social insurance to introduce measures which tend to make competition more or less ineffective. \(^1\)

Citing this passage, Washington Post reporter Dylan Matthews has asserted that Hayek would have supported a far more comprehensive system of health insurance than the Affordable Care Act, calling it "less ambitious than the sort of thing he's talking about here". While a Hayekian system of health insurance would certainly be an ambitious undertaking, it would seek to utilize, not subvert, the forces of the market and the information carried by prices. In direct contradiction to the Affordable Care Act, a Hayekian system of health insurance would not be comprehensive.

Under the Affordable Care Act, those firms selling insurance must cover a laundry list of conditions, and provide services under insurance that many customers would prefer to purchase piecemeal. Addiction treatment, depression screening, and prescription eyeglasses for children are all mandated under the bill, driving up the cost of purchasing any sort of health insurance. We are only able to discover how consumers of healthcare wish their services to be provided,



what they want covered under their plans, and what services they would prefer to purchase separate from insurance, by allowing them free choice in their purchasing decisions, and allowing healthcare providers flexibility in altering their provided services in response to the price signals generated by the purchase, or non-purchase, of their goods. In Chapter 19 of "The Constitution of Liberty", Hayek speaks to the impossibility of centrally mandating requirements of health insurance coverage.

There is no objective standard for judging how much care and effort are required in a particular case; also, as medicine advances, it becomes more and more clear that there is no limit to the amount that might be profitably spent in order to do all that is objectively possible. Moreover, it is also not true that, in our individual valuation, all that might yet be done to secure health and life has an absolute priority over other needs.

In light of this lack of consensus, the most moral, and economically viable solution to questions regarding the scope of insurance coverage is to allow individual purchasing choices, and the prices they generate, to drive coverage norms.

The approach of the Affordable Care Act also completely ignores the power of market competition to drive down prices. Under a system in which all healthcare is provided through insurance, the patient receiving the healthcare is not really the consumer. The patient does not choose which doctor or hospital to patronize, and as a result, there is little pressure for the doctor or hospital to best meet his needs. Instead, the consumer is the insurance company. While doctors and hospitals might change their pricing and care provision models to attract the patronage of insurance providers, there is little incentive for insurance providers to put the interests of their customers ahead of the interests of their firm, especially when insurance companies have little choice in what they cover, and their prices face no downward pressure from the providers of a la carte medical services.

In the early 1990's, LASIK corrective eye surgery cost nearly \$2,500 per eye. Today, the same surgery costs just \$500 per eye, and uses more advanced technology, ensuring quicker, more precise, and ultimately safer corrective surgery. The price

of LASIK has fallen, even as the price of other healthcare services increase, because LASIK is not covered by health insurance. As a result, consumers desiring corrective eye surgery shop around, comparing the prices and reputations of various LASIK providers. Competition between providers of corrective eye surgery has driven prices down, and increased quality. In the Hayekian sense, prices have been allowed to work their magic, free from the distorting effect of surrogate customers.

A Hayekian system of national health insurance could function in one of two ways. Taxes could be paid into a common pool, from which funds could be drawn by individuals experiencing a catastrophic healthcare crisis. After being, say, struck by a vehicle, one could draw a set amount of funds from this pool, and use aforementioned funds to pay whatever hospital best suited the individual in question. Treatment for other, non-catastrophic health concerns could be purchased by individuals privately, and would function similarly to other purchased services. This would help to pay for currently funded emergency room visits, but would do little to provide the poor with access to routine preventative care, and would prevent their knowledge and preferences from being translated into the prices for LASIK surgery. This system would, however, have a very limited distorting effect on healthcare prices.

Another option is an annual cash payment to those unable to afford healthcare. It could be mandated that this money be spent on healthcare or health insurance, though this mandated cash influx would likely have some sort of distorting effect on the signals generated by healthcare prices. However, these distortions would be minute when compared with the effects of direct price controls imposed by traditional systems of government health insurance, such as those under Britain's NHS. Firms would likely engage in political rent-seeking, attempting to have their services included under whatever legal definition of healthcare was adopted in order to secure positions for themselves as possible recipients of the healthcare payments. Hayek undoubtedly understood such rent-seeking tendencies, but was nonetheless at least open to the idea of a health insurance mandate, proposing it as a possible option in "The Constitution of Liberty". Hayek scholar Erik Angner advocates





for the annual payment approach, noting that "most people able to purchase health insurance usually do".⁵ If this holds true, a mandate and its associated distortions might not be necessary, instead, the amount of insurance provided would be driven by the amount desired, and those few who truly had no interest in healthcare could spend their stipend on other goods. This option, while not as politically palatable as a stipend attached to a mandate, would be likely to provide the best healthcare to everyone who desired it, while creating the fewest number of price distortions, a far better option than single payer systems or mandates.

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On the Use of Knowledge in the U.S. Health Care System

Author:

MARTA PODEMSKA MIKLUCH Beloit College As I sit down to write this essay, the shutdown of the U.S. Government enters its third week. The shutdown has been caused by the Republicans' effort to defund the Patient Protection and Affordable Care Act (PPACA). The GOP has opposed the health care reform because, according to its main strategist, "ObamaCare is going to be the end of the American free-enterprise health-care system" (Moore 2013). Democrats fight back, arguing that the reform is necessary because the existing health care system is inequitable and leaves many individuals without the necessary care. In the words of the late Democratic Senator Ted Kennedy, "what we face is above all a moral issue; that at stake are not just the details of policy, but fundamental principles of social justice and the character of our country" (Kennedy 2009).

Both sides of this highly politicized debate would benefit from studying Friedrich Hayek's exposition of the coordinating role of prices (Hayek 1937; Hayek 1945). In fact, Hayek's insights have a broader application: they illuminate many aspects of the health care conundrum ignored in the partisan talking points. For example, despite what Republicans seem to believe, the third-party payment system, along with the countless layers of contradictory regulations embedded of the pre-reform structure, render it unfit to the definition of a free enterprise. Nevertheless, ObamaCare does little, if anything, to address these problems. In this essay, I address the inefficiencies of the U.S. health care, in particular third-party payments, from the perspective of Hayek's contributions to the economic calculation debate.

COORDINATION PROBLEM IN THE THIRD-PARTY PAYMENT SYSTEM

One of the main issues in the health care debate is growing expenditure. According to the data gathered by Centers for Medicare & Medicaid Services (CMS), in the United States, health care expenditure has increased 40 fold since 1965. However, not the entire increase is contentious (Feldstein 2011). A small portion is attributed to the growth of income: wealthy people spend more on health care than poor people. Another fraction is attributed to technological innovation. More medical services are available now than in the 1960s; the health care of today offers a much richer bundle of products. There were no carbon prosthetics in the 1960s and no ventricular assist devices. And since the fact that Millennials spend more on personal computers and cell phones than Baby Boomers did, is not a policy dilemma, neither should be health care innovation.

This being said, majority of the expenditure growth, is not an outcome of innovation but rather is an indication of inefficiencies that pollute the system. Researchers agree that institutional matters, i.e. benefit levels and payment methods are the predominant reason behind the expenditure growth (Gerdtham et al. 1992; Hagist and Kotlikoff 2005). In this regard, 1954 brought the first major change when the Internal Revenue Service ruled that compensation in the form of health insurance is tax exempt. This policy lead to a dramatic expansion of the employment-based group health insurance and laid a founding stone under the third-party payment system (Thomasson 2003). The second change came in 1965 when government insurance for the elderly and the impoverished was established. These two changes generated third-party payment system under which insured patients are not financially responsible for their health care choices. As a result, since 1965, out-of pocket expenditure on health services has fallen from 79.5 to 52.6 percent (Feldstein 2011).





In the light of growing expenditure, government, hospitals, and private insurers experimented with a variety of cost containment measures. Among them were Medicare utilization reviews, restrictions on hospital investment, limits on physician fee increases, expansion of Health Management Organizations (HMOs), and introduction of Pay for Performance (P4P) programs. However, with an exception of HMOs, other measures had a negligible or even counterproductive effect on the growth of health care expenditure, contributing more to cost shifting than to cost containment (Fuchs 1993; Mays, Claxton, and White 2004; Orentlicher 2010).

THIRD-PARTY PAYMENT SYSTEM FROM A HAYEKIAN PERSPECTIVE

Would Hayek be puzzled by the ineffectiveness of cost containment efforts? Unlikely. Rather, he would attribute it to the poor utilization of knowledge in the third-party payment system. To Hayek, the economic problem that society faces is "how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know" (Hayek 1945 p.520). In order to allocate resources to their most valuable uses, individuals need to know profitability of alternative applications. This knowledge, though, is dispersed throughout the economy. As a result, individuals require navigational aids and prices play fulfil this function by aggregating all relevant knowledge into a single index. It is because of prices that "without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly; i.e., they move in the right direction" (Hayek 1945 p.527)

Prices, however, are meaningful only in the environment of private property rights. In the absence of private property, prices are meaningless; they contain no useful information pertaining to relative scarcity. As a result, they are of no help to decision-makers (Mises 1920; Boettke 1998). Viewed from the Hayekian perspective, the ineffectiveness of cost

containment efforts is an unavoidable outcome of the poor utilization of knowledge due to the lack of private property rights. The third-party payment system is incapable of aggregating information, necessary for the efficient allocation of resources, because it operates in the commons.

For the same reason, Hayek would not be surprised by the results of the recent study that examined unwillingness of insured patients to consider health care costs in selection of medical treatments (Sommers et al. 2013). The study focused on patients who suffered from a prolonged headache. Observed patients were told, during an office visit, that Computerized Tomography (CT scan) would identify nearly all of the problems for a fraction of the cost of a Magnetic Resonance Imaging (MRI). For majority of the patients this information was of no consequence—predominantly, patients refused to limit their consumption to the less expensive option.

Interestingly, the researchers responsible for the study were taken aback by the findings. In the interview for a medical newsletter, one of the authors admitted that the team was surprised by "how firmly and frequently people talked about not wanting cost considerations to factor into decision-making at all" (Andrews 2013). This sense of surprise is foreign to anyone familiar with Hayek's elucidation of the coordinating role of prices: once private property rights and market prices are understood as the key elements in the process of knowledge utilization, there is nothing unusual about patients' immunity to changes in collective health care expenditure. Inefficiencies are an expected outcome of central planning, only individuals can judge the relative importance of different ends, it is the individuals that must be in charge of planning.

As if in a twisted response to Hayek, Obama administration now requires that hospitals reveal prices, or more accurately, the amount billed for an item or service. While the policy is supposed to help patients economize on health care, it is highly unlikely that Hayek would be satisfied with this move. The published database does nothing to improve the way in which knowledge is utilized in the system because published prices are not related to what the patients pay for the treatment. They are not even much related to what the insurance



companies pay. Rather, the list documents from what amount hospitals start to negotiate with an insurance companies.

Prices play their coordinating role by telling individuals how much of one good they would need to give up in order to obtain a different good or service. The mandated publication of hospital charges is of no consequence in this regard. The published prices have no impact on the trade-offs that patients face, they contain no information of how much of other resources to give up in order to get an additional medical exam. Instead, as can be concluded from Hayek's treatment of prices, what would make a difference is paying for the exam from one's own pocket. For example, it is reasonable to presume that, if the above survey was altered so that patients were offered a choice between an additional exam and \$1,000, the findings would be significantly different (Cochrane 2013).

CONCLUSIONS

Hayek was not an anarcho-capitalist; he did not deny that there was a role for the government in a free society (for a fascinating overview see Caldwell 2003). This role however, in Hayek's view, should be minimized so that prices can play their coordinating role. As he argued in The Road to Serfdom, the more of the planning is done centrally, the more challenging planning becomes for the individual (Hayek 2009 [1944]). If Hayek could participate in the health care policy debate today, he would be in favour of proposals for a consumerdriven health care (Goodman 2012; Cochrane 2013; Topol 2012), with well-defined private property rights and little room for arbitrary intervention. Given his more specific policy recommendations, as outlined in the Constitution of Liberty (Hayek 1960), there would still be a collective element in the system. But its extent would be negligible compared to the current state of affairs and it would operate within laws predictable and equally applied laws.

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Hayek on Education: Designing Markets for Spontaneous Orders

The fundamental principle that in the ordering of our affairs we should make as much use as possible of the spontaneous forces of society, and resort as little as possible to coercion, is capable of an infinite variety of applications. There is, in particular, all the difference between deliberately creating a system within which competition will work as beneficially as possible, and passively accepting institutions as they are (Hayek 2001 [1944]: 17-18).

Author:

GABRIEL H. SAHLGREN
London School of Economics

Most areas of society have progressed significantly in the past centuries. Education, however, is a conspicuous exception to this rule. Classrooms today look very similar to classrooms a century ago; the progress characterising modern society does not generally apply to education. This essay discusses the relevance of Hayek's ideas for improving today's primary/secondary education systems. While Hayek would have welcomed moves to introduce market mechanisms in the sector, he did not envisage complete laissez-faire. This is because of positive externalities, which he argued warrant some government involvement in basic funding and standards. In fact, contemporary evidence regarding information asymmetries is likely to have persuaded Hayek further about the need for education market design before evolutionary progress may occur.

A straightforward application of Hayek's general ideas to education must highlight the lack of markets as key for its stagnation. Most education systems remain strongly centralised, with relatively little choice and competition (Sahlgren 2013). Naturally, Hayek's (1945) ideas of markets as discovery processes that convey information dispersed throughout society, thus limiting individual actors' lack of knowledge, are relevant here. Without competition between autonomous suppliers and a price mechanism to guide market players, gradual improvements will not occur. Some form of parental payments and private school choice would thus be necessary to convey information to schools regarding the type of education that should be produced (and how), while indicating to parents which schools are most effective. Competition would then eliminate bad schools and ensure that effective ones gain market shares.

Indeed, Hayek (1960) explicitly supported a stronger role for markets in education. Public funding and compulsory schooling to a certain level are necessary because of positive externalities, such as a well-functioning democratic state and overall societal wealth. But he also underscores the importance of allowing competition between different suppliers, expressly suggesting that Friedman's (1962) voucher idea would solve the tension between the need for some government involvement and the dangers of too centralised government schooling. In general, provision could be left to private actors, with the state merely ensuring basic funding and standards. Thus, Hayek clearly supported moves toward privatisation/marketisation, while still keeping the government involved as a financier and gatekeeper of minimum requirements.

Thus, rather than letting unconstrained market forces determine the organisation of education systems entirely, Hayek appears to suggest a role for market design. An important example concerns curricula. In general, Hayek favoured a broad rather than narrow education. This is displayed by his disapproval of the specialised scientific schooling in institutions such as the German Realschule and the French École Polytechnique, which he accused of producing minds pre-disposed to 'scientism'. Excessive applied/technical training may instil in pupils a false sense that social problems can be rationally planned away, while giving them 'little or no



knowledge of society, its life, growth, problems, and values, which only the study of history, literature, and languages can give' (Hayek 2010 [1952]: 176). The emphasis on a liberalarts education is clear here. Of course, allowing diversity in schooling decreases the risk that everyone will be educated in the applied/technical tradition. But for Hayek, the key source of scientism is a zeitgeist originating in the French Enlightenment. And in such a zeitgeist, it is certainly possible that markets would generate strongly specialised schools en masse because of high demand for them.

Hayek's general ideas of market discovery may thus be predicated on education systems that are partly shielded from that process, since schools instilling pupils with rationalist mind-sets also generate pressures for interventionism. For example, citizens with an excessively applied schooling might be more likely to view social engineering favourably, and thus vote for similarly schooled politicians who support increased intervention in the economy. For Hayek, therefore, a general education is essential for liberal society itself, producing gradual progress 'within an established order whose traditions and values it affirms' (Miller 2010: 177). Education is both preservative and progressive—which requires a delicate balance between competition and minimum requirements.

Yet, the argument favouring government regulation of education content should not be overstated. Indeed, Hayek (1960) expressly warns about too much interventionism in this respect. Liberty remains a key value since it is essential for progress in society at large, and also for minimising social conflict between people with different views of what constitutes good schooling. For these reasons, outright government provision of education is dangerous and should be avoided.

Furthermore, it is impossible to know how positive externalities are best produced, which Hayek is likely to have emphasised. Take the potential trade-off between cognitive and non-cognitive outcomes. Relevant here is the debate regarding the relative virtues of traditional and progressive teaching methods.² While the latter appear to be bad for academic achievement, they seem to be good for instilling social capital (e.g. Algan, Cahuc, and Shleifer 2011; Schwerdt

and Wuppermann 2011). Both academic achievement and social capital yield positive externalities, but there is little way of knowing which the state should prefer as a matter of policy. Generally, therefore, Hayek would probably have left decisions regarding the trade-off between 'hard' and 'soft' quality—and the different pedagogical methods involved—to markets.

However, another issue of relevance here concerns information, which, as noted above, is key for Hayek's general argument in favour of markets and the price system. In education, unfortunately, there are strong information asymmetries, which cannot necessarily be solved by the market discovery process. This is because quality is more difficult to observe in education compared to many/most other goods/services (e.g. MacLeod and Urquiola 2012). For example, parents often seem to value schools with high average test scores because they think these schools produce high academic quality. Yet, this assumption does not necessarily hold true—schools often have high average test scores because they enrol high-performing pupils, not because they are more effective (Sahlgren 2013).³

The difficulty to observe 'hard', academic quality means that markets may not be sufficient to produce the discovery process regarding what works and what does not work in education. The reputation mechanism, which is an important conveyor of information, may in that case be built on the wrong premises, making people choose and pay high fees for schools that are not more effective. Of course, these schools might still provide high 'soft' quality, which is best displayed by revealed parental preferences (Neal 2010), but there is a risk of market failures in terms of 'hard' quality.

Theoretically, effective schools do have incentives to disclose their quality to distinguish themselves from low-effective schools, which should give rise to 'unravelling' in which all schools eventually disclose their quality. However, this is often not the case in practice. For example, schools rarely release their test scores voluntarily (Dranove and Jin 2010). And even if unravelling did occur, it is not clear whether schools would have stronger incentives to disclose information approximating the quality of their pupils or their effectiveness.





Thus, armed with contemporary evidence, it is likely that Hayek would have favoured some state involvement in ensuring appropriate information in the education market. Yet, as with education provision, he is unlikely to have supported a direct role for the government as a provider, but rather a mandate regarding the release of data. Other private agents could then use the raw statistics to devise new information measures with which they could compete for parents' attention. Hayek's solution to the problem of identifying 'hard' quality in education would thus most likely have been to produce markets also in information provision.

Thus, in conclusion, Hayek's views on education policy today would be complex. First, it is clear that he would have been in favour of abolishing the status quo through liberalisation and decentralisation, partly in the form of a voucher system. However, given the special properties of education, it is clear that the opening quote to this essay is highly relevant. Laissez-faire is not sufficient. Instead, Hayek would have emphasised a continued role for the government in funding, the setting of minimum requirements, and (probably) ensuring relevant quality information. Essentially, in education, the great champion of spontaneous orders supported the design of market structures within which those spontaneous orders could develop.

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- Traditional teaching methods involve a high degree of whole-class teaching, whereas progressive methods involve a high degree of group work and individualised coaching.
- Theoretically, peer effects are frequently cited as a reason for why schools with high average test scores should also be effective. Yet, it is difficult to draw this conclusion from the empirical literature, which is quite mixed (Sacerdote 2011).

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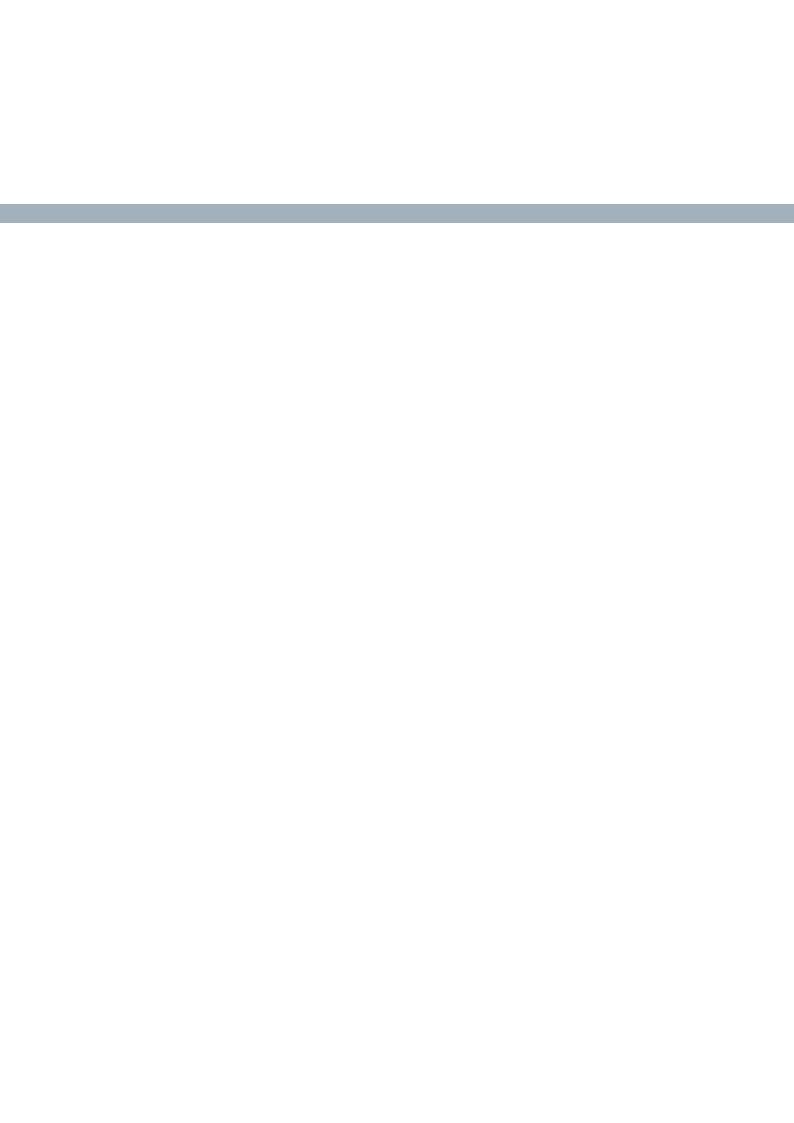
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DECEMBER 2013