USING HAYEK TO DEFEND KEYNES

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Hayek's reputation rests mainly on two activities. In the 1930s he worked as an economist, producing arguments in economic theory; and after the Second World War he turned to political philosophy, developing arguments for individualism. In his own mind, his contributions to economic theory and political philosophy all supported his critique of collectivism, of which Keynesian policies were a part. In this note, I will present a different interpretation, arguing that Hayek's most important arguments in economic theory can, paradoxically, be used to support Keynesian conclusions. Indeed, it can be argued that Hayek's perspective on the function of markets is close to being a precondition for Keynesian theory.

Hayek's most profound theoretical argument is that markets are indispensable because of their role as an information-processing mechanism. Without markets and prices, the information necessary for allocating resources efficiently will not exist. Prices tell us, for example, that there is a shortage of shoes and a glut of hats, meaning that resources should be moved from hat-making to shoe-making. If wages are high and the rate of interest is low, this signals to firms that they should try to economise on labour, perhaps by investing in more machinery. Prices (wages and the rate of interest are prices as much are the prices of shoes and hats) are essential.

It is widely assumed that such arguments establish that market economies will inevitably be superior to planned economies. However, this does not follow.

The main assumption underlying Hayek's argument about market economies as information-processing mechanisms is that information is dispersed among millions of people. Some knowledge (for example, scientific knowledge) can be communicated through the written and spoken word but there is much tacit knowledge that, almost by definition, cannot be acquired by a central authority. In addition, efficient economic calculation requires not only technical knowledge but also knowledge of what Hayek called "the particular circumstances of time and place" (Hayek 1945, p. 521). It requires local knowledge, including information about what people like and want. Such knowledge is inevitably dispersed among large numbers of people.

When people engage in market activity, buying and selling goods and services (including selling their own labour) they influence prices; their behaviour will reflect their private information. Goods that are scarce in relation to the demand for them will command high prices, and goods that are plentiful will be cheap. This means that to calculate the most efficient way to produce goods, all a business needs to do is to choose the most profitable activities. For example, if a battery manufacturer discovered a way to make batteries using cheap sodium instead of expensive lithium, it will switch from lithium to sodium, raising the price of sodium relative to lithium. This change in market prices will sending a signal to other firms to reconsider what they are doing. By responding

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to market prices, people will change their behaviour appropriately, even without knowing the details of battery manufacturing.

The argument is strengthened by the recognition that much information does not exist independently of what people do. People learn by doing. There is no book of blueprints for all possible production techniques; people will know only about techniques that have already been tried and even those may involve tacit knowledge that cannot be communicated because it is subconscious. Hayek's argument is that new production possibilities become known only as a result of the trial and error that is part of the competitive process.

When stated in this way, such arguments can easily make markets sound perfect. However, there are important limits to the ability of markets to convey information and hence to their ability to guide people to use resources efficiently. One critique has been made by Joseph Stiglitz and Sanford Grossman (1980). If people act on the basis of their private information, they will inevitably convey part of that information to the wider world. Acquiring information is generally costly. Suppose that you discover there will be a glut of coffee and the price will fall. If you make use of that information to sell coffee short, you will thereby telling other people that there is someone in the market who believes the price is going to fall. This means that you can get some benefit from investing in acquiring knowledge, but you cannot get the full benefit so you will under-invest in acquiring knowledge. The result is that, if it is costly to acquire information, even the best, most competitive market cannot be completely efficient.

Another important dimension to Hayek's argument is his critique of equilibrium theory. This too is an argument about knowledge. Equilibrium means that the plans of every individual are consistent with the plans of every other individual. It is a very powerful assumption because it means that everyone's beliefs—their subjective knowledge—must correspond to the objective data, for otherwise they would discover that their beliefs were mistaken, and their beliefs would change. This means that if markets are in equilibrium, people's decisions must be based on correct information, meaning that the market is guiding them to take correct decisions.

Hayek pointed out that theories that assume equilibrium—that simply assume supply equals demand in all markets—as many theories of competitive markets do, fail to explain how equilibrium comes about. Equilibrium theories show that if people have knowledge, resources can be allocated efficiently. The problem is that knowledge will exist only once equilibrium is achieved. We *need* an explanation of how equilibrium is achieved. Put differently, Hayek's argument is that, if we are to draw useful conclusions from theories about equilibrium, we need a causal explanation of how markets reach equilibrium.

In order to go from such arguments to a demonstration that markets are superior to central planning, we need to show how "the spontaneous interaction of a number of people, each possessing only bits of knowledge, brings about a state of affairs in which prices correspond to costs, etc." and that such a state of affairs "could be brought about by deliberate direction [central planning] only by somebody who possessed the combined knowledge of all those individuals" (Hayek 1937, p. 49). The limitation of his argument here is that at this point Hayek abandons the search for a theoretical argument and simply asserts that experience shows us that "something of this sort does happen."

This is where the discussion turns to Keynes. His experience—his interpretation of what he observed going on in the world—was that this would not always happen. He observed that the spontaneous actions of many individuals could result in a Great

Depression, and he tried to work out a theory that could explain why this could happen.

For reasons I will not go into, Keynes presented his theory as a theory of equilibrium. Mass unemployment was an equilibrium in two senses. It was a situation in which economies got stuck, much like a ball in the bottom of a bowl stays there. This explained why the actions of private individuals could not solve the problem and why some intervention by government was needed to restore full employment.

However, in trying to provide a theoretical argument about how such a situation could arise, he argued that this was an equilibrium in another sense. He argued that it was a situation in which individuals were acting in their best interests given the situation they faced and the information they possessed. Here, his arguments were found wanting by supporters of his ideas as well as by those who, like Hayek, believed his theory to be fundamentally mistaken. In other words, he had failed to show that the competitive process described by Hayek might fail.

One way to resolve the problem is, as economist Axel Leijonhufvud (1968) argued, was to take up Hayek's argument that it is necessary to develop a theory of causal processes—not a theory of equilibrium in which all plans are necessarily reconciled with each other. As Hayek understood, if we are not in equilibrium, plans are inconsistent and therefore some people will inevitably find that their plans are not realised. For example, people may find that they cannot work the number of hours they want to work, which means they will have to cut back on their spending. If this happens, because people are not buying the goods they would ideally like to buy, businesses find that they have unsold goods and have not made the profits they expected to make. Such "spillover effects"—the effects of disequilibrium in one market having repercussions on other markets—interfere with the ability of markets to convey information that would result in the ideal equilibrium being established.

In other words, if we try to take Hayek's admonition that we need a theory of causal processes seriously, and if, as is inevitable, such causal processes involve disequilibria, then the theoretical case for the efficiency of the market is undermined.

Where does this long theoretical argument leave us? It does not mean that central planning is superior to a market economy. There is good reason to believe that a planned economy without markets and without prices will generally be inefficient for the reasons identified by Hayek. But individualistic capitalism is also likely to be inefficient. As Hayek's statement about the lessons of experience concedes, the question is an empirical one. Hayek believed that markets generally worked better than planning, whereas Keynes and many of his followers believed that experience taught them that government intervention, however imperfect, could improve economic performance. For example, this was the view of one of the most influential Keynesian economists, Paul Samuelson, who denounced Marxian socialism and pure libertarian capitalism as two failed gods, citing what he called "the brute fact" that it was "the mixed-market economy in the Age After Keynes" that had significantly outperformed communist societies (Samuelson 1999, p. 30). More recently, it is widely believed that the turn away from social democracy to "neoliberal" policies has led to outcomes that are worse in important respects.

Hayek's intuitions that markets should be seen as information processing mechanisms and that we need causal accounts of how markets work were profound. These intuitions provide good reasons for believing that markets are essential, a point with which Keynes agreed completely. However—and this is the critical point—Hayek's theoretical intuitions

about markets can be developed into not only a critique of central planning, but also into a critique of markets. Planning and markets are both likely to be imperfect. This means that the choice between the two cannot be made on the basis of abstract, theoretical arguments. Evidence on how different systems work out in practice needs to be found. Putting the arguments of Hayek and Keynes together it seems plausible to argue that the extreme cases of a system in which all decisions are taken by a central planner and a system of pure individualism are unlikely to be optimal; but that leaves an enormous variety of systems in between. In short, Hayek's theoretical arguments about markets can be used to defend the social philosophy associated with Keynes.

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THE ELGAR COMPANION TO

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