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REVIEW ESSAY

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# The Puzzle of Hayek



GERALD P. O'DRISCOLL JR.

**T**he *Commanding Heights*, the award-winning PBS series, chronicles the ideological battles of the twentieth century. At the beginning of that century, there was a liberal world order. Classical liberal ideas still prevailed in the West. With the advent of the Great War, the liberal world order crumbled, and liberal ideas were eclipsed. Communism, fascism, and Nazism flourished. The upshot was a second global conflagration, followed by the Cold War. By the end of the century, all the “isms” had been eclipsed in turn, and liberal ideas flourished once again.

In many ways, the tale told by *The Commanding Heights* parallels the life and career of Friedrich A. Hayek. Born in 1899, Hayek grew up in a liberal world, adopted liberal ideas, and became one of the foremost classical liberals of his day. He was an advocate of free markets and free trade, the economic program of liberalism. His ideas would come to be scorned, however, as liberalism went into eclipse. Before he died, though, he saw many of his ideas vindicated. In 1974, he was awarded the Nobel Prize in economics.

In the first volume of his trilogy *Law, Legislation, and Liberty* (1973), Hayek provided a succinct statement of liberalism’s credo. It is a message for our times: “That freedom can be preserved only if it is treated as a supreme principle which must not be sacrificed for particular advantages was fully understood by the leading liberal thinkers of the nineteenth century, one of whom even described liberalism as ‘the system of principles.’ Such is the chief burden of their warnings concerning ‘What is seen and what is not seen in political economy’ and about the ‘pragmatism that contrary to the intentions of its representatives inexorably leads to socialism’” (57).

In *Hayek’s Challenge: An Intellectual Biography of F. A. Hayek* (2004), Bruce Caldwell synthesizes his life’s work on Hayek, methodology, and the history of eco-

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conomic thought generally. Caldwell is an accomplished historian of thought, and he has written a comprehensive reassessment of Hayek and, indeed, of the Austrian school of economics more broadly.

*Hayek's Challenge* is a demanding a book. No primer, it would be suitable for use in a graduate-level seminar on Hayek and twentieth-century economic thought. In order to set the stage for presenting Hayek's contributions, Caldwell begins with a 130-page history he calls "The Austrian School and Its Opponents—Historicists, Socialists, and Positivists." In it, he examines Hayek's intellectual precursors and the debates that formed the background to economic thought in the early twentieth century. This introductory material constitutes nearly 25 percent of the length of the book, so readers skip it at their peril. After setting the historical scene, Caldwell systematically presents Hayek's ideas on economics, politics, and philosophy. Here I begin, as Caldwell does, with Hayek's precursors.

## The Austrians

It all begins with Carl Menger in 1871. As Caldwell observes, "Menger's *Principle of Economics* is the founding document of the Austrian School of Economics, yet, as its name implies, it is basically a textbook" (p. 19). But what a textbook! In it, Menger developed what became "fundamental Austrian tenets: the connection between time and error; the causal-genetic or compositive methodological approach; and the notion of unintended consequences" (p. 47). We meet all these ideas again in Hayek.

Caldwell identifies four reviews of Menger's *Principles*. In one of them, Gustav Schmoller, the leader of the Younger German Historical School, rejected Menger's efforts to present a theoretical account of economic phenomena based on a subjective theory of value. Schmoller insisted that a historical-statistical approach was the "sole legitimate way to study economic phenomena" (37). (Caldwell's appendix A consists of an English translation of the review.)

Schmoller's review led to a rebuttal by Menger in the form of another book in 1883, which in turn launched the war over method, the *Methodenstreit*. Methodology deals with the principles, rules, and procedures for determining the truthfulness of propositions in a discipline. At the most general level, the war raged over the role of deductive theory and empirical investigation in economics. To simplify, Menger defended theory, and Schmoller defended statistical and historical investigations (pp. 64–78).

The debate has haunted the Austrian school throughout its own history. Generally, the historical school (and successors, such as the American institutionalist school) sought to derive empirical laws of economics from history. The Austrians denied that any historical laws exist. We get knee-deep in these issues in Hayek's work.

In Caldwell's assessment, with which I agree, the *Methodenstreit* created "a separate Austrian *school* of economics" (p. 80). Two of Menger's students, Eugen von Böhm-Bawerk and Friedrich von Wieser, were most responsible "for spreading the

fame of the Austrian School worldwide, especially in the English-speaking world” (p. 80). Böhm-Bawerk gained fame for his work on capital theory and for his devastating attacks on Karl Marx (pp. 81–82).

Caldwell deals with many other important figures, of whom Max Weber is only one of the most notable, in his presentations of economics in the last quarter of the nineteenth century and in the early twentieth century. Most noteworthy, however, is Ludwig von Mises.

Mises remains a highly controversial figure whose work elicits strong opinions both pro and con. Caldwell is notable for the fair and even-handed manner in which he presents Mises’s ideas. Mises is best known for his presentation of economics as the science of human action. He argued that “all human action is rational” (pp. 122–23) and contended that economic theory is true a priori (pp. 124–26). Caldwell charitably observes that “Although Mises was always careful to explain in detail what he meant, his idiosyncratic use of terms made it much easier for him to be misread, especially by those who disagreed with him or who sought to discredit his ideas” (p. 123, n. 18). Caldwell presents just enough of Mises to render intelligible the debates over apriorism and methodology more broadly that so heavily occupied Hayek.

## Hayek’s Achievement

Caldwell began his project with an incident in which I was involved. While he was visiting New York University in the spring of 1982, I handed him a copy of Terence Hutchison’s new book and asked if he agreed that Hayek had done a U-turn on methodology as Hutchison claimed. Had Hayek moved from Misesian apriorism to Popperian falsificationism? I thought Hutchison’s claim to be facially false, but I respected Caldwell’s opinion. And so the present tale begins (p. 2).

As I read Caldwell today, he maintains that Hayek’s views on methodology did change, but not in the way Hutchison posited. Hayek was never a Misesian apriorist—a point on which Caldwell, Hayek, and I are in complete agreement. Both Hutchison and Caldwell zeroed in on a famous essay by Hayek, “Economics and Knowledge” ([1937] 1948). Caldwell titles a critical chapter in his book “‘Economics and Knowledge’ and Hayek’s Transformation” (pp. 205–31). He reinforces the idea of an intellectual break in Hayek’s thought in his further assessment of that essay (pp. 337–39). He is even more strident in advancing a “transformation” interpretation in confronting a “continuity” interpretation by Jack Birner given in appendix B (pp. 409–18).

There is, however, a kinder and gentler Caldwell with whom I agree. “We can discern a gradual change in Hayek’s views regarding the equilibrium construct from the late 1920s through the early 1940s. Of course, even in his earlier work there was a certain ambivalence” (p. 224). In other words, Hayek grew over time, as does any serious intellect. And his work always had tensions within it—“ambivalence,” if you will—as does the work of any interesting theorist. The latter point is very important.

If the different strands of thought were simultaneously present in Hayek's early work, then we can properly talk of "synthesis," not "transformation," in the later work. There was one Hayek, not two as Caldwell suggests.

In "Economics and Knowledge," Hayek posed two different questions about knowledge. What do ordinary people know about the world, and what do economists know about ordinary people? Economists' concept of equilibrium "could be properly defined only in terms of assumptions concerning foresight. The situation seems here to be that, before we can explain why people commit mistakes, we must first explain why they should ever be right" ([1937] 1948, 34).

Equilibrium is a key concept in economics. Intuitively, it connotes a state of rest in which economic forces are in balance. In its simplest application, an equilibrium price is one at which the quantity of a good demanded is equal to the quantity supplied. How economists deal with this concept reflects their views on broader methodological questions in economics.

Caldwell identifies four main points Hayek made in "Economics and Knowledge." First, equilibrium can be defined only in terms of foresight (pp. 206–7). The reason is that actions take place in time, though Caldwell does not specifically note this point. Next, Hayek distinguished between equilibrium for an individual and that for society. In Caldwell's words, "An individual's actions are always based on a plan, and that plan is based on subjective perceptions of the objective facts. Of course, the individual may at some time discover that his perceptions are wrong, in which case the equilibrium position would change. But, in terms of the individual's subjective perceptions *at a given point in time*, equilibrium for the individual is a tautology; it follows trivially from the pure logic of choice" (p. 207). The third point is already apparent: knowledge is subjective. An economist must always distinguish between what an individual economic agent knows and the actual facts, or objective reality. The economist cannot ascribe to an agent knowledge that the agent cannot possess in that situation. As Hayek posed the question, "[W]hy the data in the subjective sense of the term should ever come to correspond to the objective data is one of the main problems we have to answer" ([1937] 1948, 39).

Finally, we must grapple with the problem of societal equilibrium in a dynamic economy. Again, I quote from a passage that Caldwell also quotes:

It appears that the concept of equilibrium merely means that the foresight of the different members of the society is in a special sense correct. It must be correct in the sense that every person's plan is based on the expectation of just those actions of other people which those other people intend to perform and that all these plans are based on the expectation of the same set of external facts, so that under certain conditions nobody will have any reason to change his plans. Correct foresight is then not, as it has sometimes been understood, a precondition which must exist in order that equilibrium may be arrived at. It is rather the defining characteristic of a state of equilibrium. ([1937] 1948, 42)

This passage is vintage Hayek. An economy comprises agents with not only heterogeneous tastes but also heterogeneous knowledge. In order for the agents' plans to be compatible, they must be mutually consistent and consistent with the external constraints. Then, "under certain conditions," plans will be coordinated, and the system will have no internal dynamic causing it to become disequilibrated. Except that this understanding contains no allowance for endogenous change, it is a thoroughly modern concept of equilibrium.

Much of the remainder of the essay deals with the knowledge problem for economists. Hayek described pure economic theory as the Pure Logic of Choice. That logic has no "empirical content." Only by adding "subsidiary hypotheses or assumptions" about how people learn from experience does economics provide propositions about the "real world" ([1937] 1948, 46–47). I agree with Caldwell that in writing these passages Hayek was distancing himself from the Mises's aprioristic formulation of the status of economic theory. Caldwell quotes Hayek's reminiscences in this regard (pp. 220–21).

To explain why I dispute that the 1937 essay represents a "transformation," I turn to some of Hayek's early work on money and business cycles. In *Monetary Theory and the Trade Cycle* ([1933] 1966a), Hayek argued for a theoretical approach to the study of fluctuations in economic activity ("the cycle"). Here he was countering the claims of Wesley Clair Mitchell and other members of the institutionalist school, who took the contrary position. The shadow of the *Methodenstreit* cast itself over the debate (pp. 157–59).

Moreover, Hayek, argued that a theory of the cycle must employ the standard equilibrium concept. Yet equilibrium theory "assumes that prices automatically equilibrate markets or that general equilibrium obtains" (p. 159). The business cycle, however, is a disequilibrium phenomenon. Accordingly, we have a contradiction (pp. 159–60). How did Hayek resolve it?

He saved the equilibrium concept by rejecting its static version and by introducing dynamic analysis. Money was the disturbing factor in the economic equation, which introduced the contradiction into static economic theory. "Money being a commodity which, unlike all others, is incapable of finally satisfying demand, its introduction does away with the rigid interdependence and self-sufficiency of the 'closed' system of equilibrium" ([1933] 1966a, 44). Thus, Hayek confronted the anomalous phenomena of fluctuating economic activity by saving theory and the equilibrium concept in the course of moving from static to dynamic analysis. The institutionalist program of studying real-world phenomena could be accomplished by using standard, deductive economic theory, but a dynamic version of that theory had to be developed (pp. 160–62).

In *Prices and Production*, Hayek detailed the real consequences for intertemporal plan coordination between consumers and producers if a monetary disturbance occurs. The plans of first the consumers and then the producers will be frustrated by the monetary shock ([1935] 1966b, 54–68). He then explained the changes in rela-

tive prices over the course of the economic cycle, these changes having been set in motion by the monetary shock ([1935] 1966b, 69–100).

In *Monetary Theory and the Trade Cycle* and in *Prices and Production*, Hayek described a lack of plan coordination. Individuals are forming consistent plans over time, given the price signals, but no compatibility exists among all these plans. The distinction between individual and societal equilibrium is already present. Present, too, are the dispersion of knowledge and, in *Prices and Production*, the subjectivity of knowledge. (In another context, Caldwell disputes the latter point, to which I return shortly.)

A third, critical contribution rounds out the story: Hayek's 1933 Copenhagen lecture "Price Expectations, Monetary Disturbances, and Malinvestments," which was not translated into and published in English until 1939 (reprinted in 1970). Caldwell acknowledges that the distinction between individual and societal equilibrium was "first hinted at" in this lecture (p. 210), and he notes that the connection between perfect foresight and equilibrium is first presented in it, too (p. 211). In the Copenhagen lecture, Hayek anticipated much more of "Economics and Knowledge," however, than Caldwell suggests. Here is a critical passage from that lecture: "The main difficulty of the traditional approach is its complete abstraction from time. . . . The assumptions of this kind which are implied in the concept of equilibrium are essentially that everybody foresees the future correctly and that this foresight includes not only the changes in the objective data but also the behavior of all the other people with whom he expects to perform economic transactions" ([1939] 1970, 139–40). We have here not only the distinction between objective data and individual forecasts, but also the idea of dispersed knowledge among individuals. In this lecture, the four main ideas Caldwell identifies as being in "Economics and Knowledge" are clearly present. I was the first to identify the Copenhagen lecture as anticipating the argument of "Economics and Knowledge" (O'Driscoll 1977, 24 and 32–33, n. 38).

I have spent so much time on the issue of continuity in Hayek's thought because Caldwell makes so much of a Hayekian transformation. In reality, Hayek gradually developed, amplified, and modified his thinking on both equilibrium and methodology.

Almost in passing, Caldwell notes that the emphasis in the Copenhagen lecture "on *time* is replaced by an emphasis on *subjectivity* and *dispersed knowledge* in 'Economics and Knowledge'" (p. 211). Surely these three concepts are intertwined. Subjectivity and dispersed knowledge are virtually two sides of the same coin. What Mario Rizzo and I (O'Driscoll and Rizzo 1985) called real time is the reason that Hayek's four points on equilibrium matter practically (pp. 59–62). In Caldwell's discussion of Menger, cited earlier, he notes that the importance of "time and error" was a major Austrian tenet. Yet he devotes so little attention to time that the topic is not indexed in his book.

I return now to the question of subjectivism in *Prices and Production*, in the context of considering Caldwell's most surprising thesis: Hayek was not a consistent

methodological individualist. The claim is startling because historically Hayek has been closely identified with methodological individualism.

Referring to *Monetary Theory and the Trade Cycle* and to *Prices and Production*, Caldwell states that “there is no tracing out of what individual agents might do; the whole analysis in both books is carried out in terms of *sectors* of an economy” (p. 414). The latter point echoes one made earlier: “Does such market-level analysis still constitute methodological individualism? It certainly may be considered consistent with it. But does it exemplify it?” (p. 162).

Caldwell tells us what would convince him that Hayek was a methodological individualist in *Prices and Production*. “He could have said: ‘The use of aggregates obscures the fact that individual agents are making decisions in an economy’” (p. 416). And Caldwell continues by saying that “were he someone whose theory of the cycle was informed by a commitment to subjectivism, he would have argued that aggregates are not things that people can perceive” (p. 416). Finally, he drives the point home, observing that “this was *not* how Hayek argued” (p. 416).

Really? In *Prices and Production*, Hayek bemoaned the separation of monetary theory from general economic theory. He laid out his case in a long passage that culminates with the observation that “it is to this ‘individualistic’ method that we owe whatever understanding of economic phenomena we possess; that the modern ‘subjective’ theory has advanced beyond the classical school in consistent use is probably its main advantage over their teaching” ([1935] 1966b, 4). Two sentences later, on the same page, Hayek stated that “neither aggregates nor averages do act upon one another.”

Compare Caldwell’s statement to Hayek’s. Hayek was a methodological individualist. In a footnote, Caldwell argues that Hayek’s appeal to subjective theory relates not to monetary theory but to “*microeconomic theory*” (p. 412, n. 1). In doing so, however, Caldwell misses the gravamen of Hayek’s argument on the unity of economic theory.

Caldwell questions whether market-level analysis exemplifies methodological individualism. If it cannot, I suppose that one cannot be an economist and a methodological individualist. We could not even analyze the effects of a supply shock on the wheat market because we would be barred from talking about “consumers” and “producers.” It is no wonder then that Caldwell finds Hayek’s cycle theory anathema to methodological individualism. *All* cycle theory and macroeconomics would need to be ruled out of an individualist agenda if Caldwell were correct.

Hayek made in his cycle theory a simplifying assumption that economists make all the time. We classify an economy by sectors on the theory that in response to a change in the data (a “shock”), within-sector variation will be less than between-sector variation. If that assumption is false, we must reclassify. This approach can be fully consistent with methodological individualism.

Another aspect of the “transformation” thesis involves a long essay, “Scientism and the Study of Society,” originally published in three parts and then incorporated in



*The Counter-revolution of Science: Studies on the Abuse of Reason* ([1942–44] 1955). As Caldwell aptly observes in his appendix D, that essay is a Rorschach test (pp. 423–38). Almost all observers concur that Hayek changed his mind sometime after that essay was published; they differ on how he changed and on whether the change was for the better.

In “Scientism,” Hayek argued that the methodology of the natural sciences and the social sciences must differ. Caldwell quotes Hayek’s reiteration of his subjectivist thesis that “so far as human actions are concerned the things *are* what the acting people think they are” (p. 244). Therefore, any efforts to test the propositions of economics empirically would be seriously constrained. The objects and facts we can observe need not correspond to the objects of human choice. The behaviorist impulse of positivism fails in the social sciences.

In later work, Hayek dropped the distinction between the natural and social sciences and adopted a distinction between “simple” and “complex” phenomena. No one disputes that he made this change in terminology or classification. But what is its significance?

In a passage from the preface to *Studies in Philosophy, Politics, and Economics* (1969), which Caldwell also quotes, Hayek said: “The reason for this is that Sir Karl Popper has taught me that natural scientists did not really do what most of them not only told us that they did but also urged representatives of other disciplines to imitate. The difference between the two groups of disciplines has thereby been greatly narrowed and I keep up the argument only because so many social scientists are still trying to imitate what they wrongly believe to be the methods of the natural scientists” (viii). At that time, many commentators thought that Hayek backed away from his earlier position, adopting the modern philosophy of science under Popper’s influence. Depending on their own views, they applauded or deplored the change.

On this issue, however, Hayek left no ambiguity. He flatly denied changing his mind on methodology after the publication of *The Counter-revolution of Science* (O’Driscoll 1975a). Moreover, he denied that Popper influenced his thinking on the nature of scientific theory. Rather, he said that both he and Popper came to their positions as a result of the common experiences of their youth. Marx and Freud were two dominant figures of the day, and both asserted that their theories were true by the nature of things. Hayek concluded that a theory true by the nature of things could not be a theory of any real-world experience. When he first came across Popper’s work, he seized on it as expressing his own ideas (O’Driscoll 1975b). In sum, Hutchison misinterpreted the relationship between Hayek and Popper. Hayek had arrived independently at his own ideas, which he found consistent with Popper’s. Further, Hayek was never an apriorist.

Moreover, contrary to both Hutchison and Caldwell, there was only one Hayek. His views on equilibrium evolved gradually as he grappled with ever more complex economic issues and found that the concept needed elaboration and development—which was exactly what he was engaged in doing steadily from the 1920s through the 1940s and later.



I am not minimizing the importance of “Economics and Knowledge,” which was, as of 1937, the clearest and most encompassing statement of Hayek’s ideas on equilibrium and foresight that he had as yet written. He advanced the argument from where it had been in his work on economic fluctuations and in the socialist-calculation debate. At the time, he himself did not appreciate fully the consistency of his own ideas. He made this point years later in a short piece titled “On the Way,” which served as the foreword to my book *Economics as a Coordination Problem: The Contributions of F. A. Hayek* (O’Driscoll 1977):

I must confess that I was occasionally myself surprised when I found in Professor O’Driscoll’s account side by side statements I made at the interval of many years and on quite different problems, which still implied the same general approach. That it seems in principle possible to recast a great part of economic theory in terms of the approach which I had found useful in dealing with such different problems as those of industrial fluctuations and the running of a socialist economy was . . . gratifying to me. . . . Professor O’Driscoll has almost persuaded me that I ought to have continued with the work I had been doing in the 1930s and 1940s rather than let myself be drawn away to other problems which I felt to be more important. (ix)

Hayek was the true inheritor of Menger’s vision of economics, even more so than Menger’s two famous students. He focused on time and error and economics, and he was a consistent methodological individualist in practice. His enduring contributions to the study of the unintended consequences of human action are among his most famous achievements. By elaborating that concept, Hayek developed a theory of institutions that spans economics and politics. A full appreciation of Hayek’s ideas on unintended consequences would require an essay in itself.

Caldwell concludes that Hayek never completed “a finished political philosophy” (347). In a narrow sense, that statement may be accurate. I am not sure that Hayek sought to do so, however, so much as he tried to reacquaint the Anglo-Saxon world with its own intellectual inheritance. He offered his most succinct statement of that legacy in a marvelous essay simply titled “Liberalism.” On that essay, I quote from something I wrote a quarter-century ago: “This essay is a gem, bringing together Hayek’s thinking in economics, politics, philosophy, cultural anthropology, and history. He is here concerned with ‘that broad stream of political ideas which . . . under the name of liberalism operated as one of the most influential intellectual forces guiding development in western and central Europe’” (1978, 39).

In *Law, Legislation and Liberty*, Hayek synthesized much of the work he had done on evolved order and rules, bringing together his ideas from all the disparate fields in which he had written. It was one of the few works in which he acknowledged, ever so briefly, the influence of natural-law thinking and the work of the late Spanish scholastics (1973, 84). Hayek went to great lengths at times to avoid obvious refer-

ence to natural law, even though so much of what he wrote was consistent with, if not inspired by, that tradition.

## Caldwell's Achievement

In *Hayek's Challenge*, Caldwell raises many other important issues, too many to discuss in a review essay. I conclude by considering briefly his contribution to the Hayek literature.

Notwithstanding my foregoing criticisms, I immensely enjoyed reading this book. My respect for its author only increased. Caldwell will challenge scholars with this book for years to come. Its sheer breadth and thoroughness ensure that it will become a standard reference work on Hayek. Indeed, it is likely to frame the debate about Hayek's thought for a long time.

Late in the book, Caldwell asks, "Which is the real Hayek? (p. 359). I have spent much of this essay also trying to identify the real Hayek. He remains elusive for many. Caldwell also asks a companion question: "Why is he so often misread?" (p. 357). The evidence is that many readers have brought a great deal of baggage with them when interpreting Hayek's thought. Hayek draws from many traditions in economics, the broader social sciences, the natural sciences, and philosophy. Hayek himself was not, however, a man of system.

Hayek was synthesizer and, in his own words, a "puzzler." He worked through a problem sometimes from one angle, sometimes from another. To some readers, that shifting about gave the illusion that he was changing his mind. Perhaps at times he *was* doing so, but not nearly so often as many have supposed. If one approaches the Tetons from different angles, one will think that he is seeing an entirely different group of mountains; as the aspect from which one views the range changes, the mountains appear to present themselves differently. There is only one mountain range, but many seeming realities. Hayek, who enjoyed the Austrian Alps, always reported what he saw from his different intellectual vantage points. The trick for a Hayekian scholar is to find the one all-encompassing view that makes sense of the whole body of thought. The quest continues.

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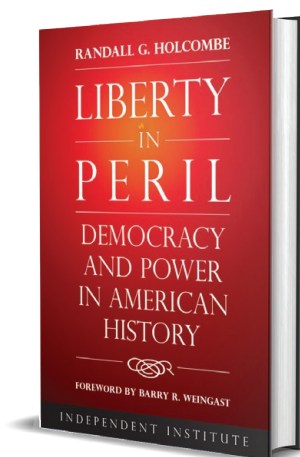
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