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Norman P. Barry, “Hayek’s Theory of Spontaneous Order I: Economic Orders” (1982)

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Norman P. Barry (1944-2008)

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Editor's Introduction

Norman Patrick Barry (1944-2008) was an English political philosopher who taught at the University of Buckingham and wrote on the thought of Friedrich Hayek, classical liberal political philosophy, business ethics, and Adam Smith's theory of "the invisible hand." Some of his works include *Hayek's Social and Economic Philosophy* (1979), *An Introduction to Modern Political Theory* (1981), *On Classical Liberalism and Libertarianism* (1987), *The Invisible Hand in Economics and Politics* (1988), *Business Ethics* (1998), and *Anglo-American Capitalism and the Ethics of Business* (1999).

Friedrich von Hayek (1899-1992) was one of the most important free market economists of the 20th century. He was a member of the "Austrian school of economics", taught at the London School of Economics, wrote extensively on banking and monetary theory, the socialist calculation debate, and the theory of spontaneous orders. He was instrumental in helping reinvigorate classical liberalism after the Second World War by helping to found the Mont Pelerin Society with Milton Friedman and others. Hayek won the Nobel Prize for Economics in 1974. Among his many important works are *The Road to Serfdom* (1944) his critique of government regulation during the Second World War, *The Constitution of Liberty* (1960) his vision of limited constitutional government, and the three volume *Law, Legislation, and Liberty* (1973-79) in which he develops his theory of spontaneous orders to encompass society as a whole. Hayek is now also famous for his then unheeded criticism of John Maynard Keynes during the 1930s.

One of Hayek's many important contributions to social and economic theory was the idea of "spontaneous order" which he took from Adam Ferguson (1723-1816) and applied more rigorously, firstly to the sphere of economics, and then to the sphere of law. Ferguson observed that many social structures were "the result of human action, but not the execution of any human design" (1782). In Barry's bibliographical essay he explores Hayek's seminal contributions to the theory of spontaneous order, first in the area of economics and then in the area of law which occupied Hayek in the latter part of his life. We have divided Barry's essay into two parts, the first on spontaneous economic orders, and the second on spontaneous legal orders.

“What is important about the theory of spontaneous order is that the institutions and practices it investigates reveal well-structured social patterns, which appear to be a product of some omniscient designing mind yet which are in reality the spontaneous co-ordinated outcomes of the actions of, possibly, millions of individuals who had no intention of effecting such overall aggregate orders. The explanations of such social patterns have been, from Adam Smith onwards, commonly known as ‘invisible hand’ explanations since they refer to that process by which “man is led to promote an end which was no part of his intention.””

Norman Barry, “Hayek’s Theory of Spontaneous Order I: Economic Orders” (1982)¹

INTRODUCTION: THE RECENT REVIVAL OF SPONTANEOUS ORDER

The theory of spontaneous order has a long tradition in the history of social thought, yet it would be true to say that, until the last decade, it was all but eclipsed in the social science of the twentieth century. For much of this period the idea of spontaneous order—that most of those things of general benefit in a social system are the product of spontaneous forces that are beyond the direct control of man—was swamped by the various doctrines of (to use Friedrich A. Hayek's phrase in *Law, Legislation and Liberty*) ‘constructivistic rationalism.’^[1] No doubt the attraction of this rival notion of rationalism stems partly from the success of the physical sciences with their familiar methods of control, exact prediction, and experimentation. It is these methods which have an irresistible appeal to that hubris in man which associates the benefits of civilization not with spontaneous orderings but with conscious direction towards preconceived ends. It is particularly unfortunate that the effect of constructivistic rationalism should have been mainly felt in economics. This is unfortunate not merely because attempts to direct economics have repeatedly failed but also because the discipline of economics has developed most fully the theory of spontaneous order.

The last ten years have seen a rehabilitation of the *economic* philosophy of classical liberalism; indeed Hayek, its major contemporary exponent, was awarded the Nobel Prize for Economic Science in 1974. But the necessary accompaniment of that economic theory, the philosophy of law and social institutions, has been largely ignored by the social science establishment. This oversight has occurred despite the fact that, for example, the bulk of Hayek's own work in the last thirty years has consisted of a theoretical reconstruction of the *social* philosophy of classical

liberalism and despite the fact that he has himself stressed that a knowledge of economic principles of resource allocation alone is quite inadequate for the understanding of the order of a free society. Indeed, the contemporary concern with specialization in the social sciences is itself an important barrier to the acceptance of the doctrine of spontaneous evolution precisely because this theory straddles so many of the artificial boundaries between academic disciplines.

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THE MAIN ELEMENTS IN THE THEORY OF SPONTANEOUS ORDER

The simplest way of expressing the major thesis of the theory of spontaneous order is to say that it is concerned with those regularities in society, or orders of events, which are neither (1) the product of deliberate human contrivance (such as a statutory code of law or a *dirigiste* economic plan) nor (2) akin to *purely natural* phenomena (such as the weather, which exists quite independently of human intervention). While the words *conventional* and *natural* refer, respectively, to these two regularities, the ‘third realm,’ that of *social* regularities, consists of those institutions and practices

¹ Norman Barry, "Bibliographical Essay: The Tradition of Spontaneous Order" in *Literature of Liberty: A Review of Contemporary Liberal Thought*, Summer 1982, vol. 5, No. 2, pp. 7-58. <oll.libertyfund.org/title/1303/100682>. This extract includes the Introduction and the section dealing with Hayek's theory of spontaneous orders in the economic sphere.

which are the result of human action but not the result of some specific human intention. [2]

‘Invisible Hand’ Social Patterns & Methodological Individualism

Despite the complexity of the social world, which seems to preclude the existence of regularities which can be established by empirical observation, there is a hypothetical order which can be reconstructed out of the attitudes, actions, and opinions of individuals and which has considerable explanatory power. What is important about the theory of spontaneous order is that the institutions and practices it investigates reveal well-structured social patterns, which appear to be a product of some omniscient designing mind yet which are in reality the spontaneous co-ordinated outcomes of the actions of, possibly, millions of individuals who had no intention of effecting such overall aggregate orders. The explanations of such social patterns have been, from Adam Smith onwards, commonly known as ‘invisible hand’ explanations since they refer to that process by which “man is led to promote an end which was no part of his intention.”[3] It is a major contention of the theory of spontaneous order that the aggregate structures it investigates are the outcomes of the actions of individuals. In this sense spontaneous order is firmly within the tradition of methodological individualism.

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Spontaneous Order & ‘Reason’

The role of ‘reason’ is crucially important here because the theorists of spontaneous order are commonly associated with the anti-rationalist tradition in social thought. However, this does not mean that the doctrine turns upon any kind of irrationalism, or that the persistence and continuity of social systems is a product of divine intervention or some other extraterrestrial force which is invulnerable to rational explanation. Rather, the position is that originally formulated by David Hume. Hume argued that a pure and unaided human reason is incapable of determining *a priori* those moral and legal norms which are required for the servicing of a social order. In addition, Hume maintained that tradition, experience, and general uniformities in human nature themselves contain the guidelines for appropriate social conduct. In other words, so far from being irrationalist, the Humean argument is that rationality should be used to “whittle down” the exaggerated claims made on behalf of reason by the Enlightenment *philosophes*. The danger here, however, is that the doctrine of spontaneous evolution may collapse into a certain kind of relativism: the elimination of the role of reason from making universal statements about the appropriate structure of a social order may well tempt the social theorist into accepting a given structure of rules merely because it is the product of traditional processes.

The ‘rationalism’ to which the theory of spontaneous order is in intellectual opposition precedes the Enlightenment and perhaps is most starkly expressed in seventeenth-century natural law doctrines. In Thomas Hobbes' model of society, for example, a simple ‘natural’ reason is deemed to be capable of constructing those rules which are universally appropriate for order and continuity. It is assumed that this reason can only conceive of a legal order in terms of rules emanating from a determinate sovereign at the head of a hierarchical system. That hidden wisdom immanent in a dispersed and evolutionary system is therefore systematically ignored in the pursuit of a statute or code structure. That other seventeenth-century natural law theorists took a more generous view of human nature, and hence produced rule structures more amenable to liberty and rights, does not alter the fact of their common anti-traditionalist and rationalist epistemology.

The theory of spontaneous order, then, is concerned with those ‘natural processes’ which are not the product of reason or intention. The classic example is the free market economy in which the co-ordination of the aims and purposes of countless actors, who cannot know the aims and purposes of more than a handful of their fellow-citizens, is achieved by the mechanism of prices. A change in the price of a commodity is simply a signal which feeds back information into the system enabling actors to ‘automatically’ produce that spontaneous co-ordination which *appears* to be the product of an omniscient mind. The repeated crises in *dirigiste* systems are in essence crises of information since the abolition of the market leaves the central planner bereft of that economic knowledge which is required for harmony. There is no greater example of the *hubris* of the constructivist than in this failure to envisage order in a natural process (which is not of a directly physical kind). As Hayek says in “Principles of a Liberal Social Order”:

Much of the opposition to a system of freedom under general laws arises from the inability to conceive of an effective co-ordination of human activities without deliberate organization by a commanding intelligence. One of the achievements of economic theory has been to explain how such a mutual adjustment of the spontaneous activities of individuals is brought about by the market, provided that there is a known delimitation of the sphere of control of each individual.[4]

Spontaneous Order & ‘Law’

Following on from this account of reason to explain spontaneous orders is a related account of ‘law.’ There are terminological problems here because theorists of spontaneous order do not always use the term ‘natural law’ to describe those general rules that govern a free society precisely because the phrase has, as we have already observed, rationalistic overtones. The ‘natural’ law of spontaneous order theory refers to regularities in the social world brought about by men generating and adapting those rules appropriate to their circumstances. Thus law properly so-called is neither (1) the dictate of pure reason in which the structure of a legal order is designed independently of experience, nor is it (2) the positive law of, say, the Command School in which all law is deliberately

created by an act of will. The theory of spontaneous order claims that in both deductivist natural law and positive law, legal structures are likely to be less regularized and more arbitrary and capricious. This capriciousness arises precisely because, to the extent that these legal structures ignore existing legal orders, they depend on a supermind both taking account of all possible human circumstances and devising appropriate rules from first principles. Rules appropriate for a spontaneous order, by contrast, are more likely to be discovered than deliberately created.

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There is, of course, implicit in all the writers in this tradition the notion of an ethical payoff: that is, we are likely to enjoy beneficial consequences by cultivating spontaneous, natural mechanisms and by treating the claims of an unaided reason with some skepticism. Well-being, in other words, is the product of a special kind of *accident*. This is a quasi-utilitarian argument used to counter the more conventional utilitarian thesis that the public good can be rationalistically summed up from the preferences of individuals and directly promoted by centralized positive law. The theory of spontaneous order claims that the very complexities of social affairs mean that such a rationalistic project is almost certain to be self-defeating, even if one could assume the existence of

benevolent and well-intentioned legislators. As Adam Smith put it: “I have never known much good done by those who affected to trade for the public good.”[5]

Two Senses of Spontaneous Order: Noncoercive Emergent Patterns vs. ‘Survival of the Fittest’

One important issue has a bearing on the explanatory power of the doctrine of spontaneous order. This centers on the fact that the theory has two interrelated meanings, which the writers under discussion do not clearly distinguish. In one sense we speak of a spontaneous order to refer to a complex aggregate structure which is formed out of the uncoerced actions of individuals, whereas in another sense we speak of the *evolutionary growth* of laws and institutions through a kind of Darwinian ‘survival of the fittest’ process (and the biological analogy is not inappropriate). In both these meanings we are describing social structures that are similar in not being of conscious design and which emerge independently of our wills, but the explanations are significantly different.[6] One version shows how institutions and practices can *emerge* in a causal-genetic manner while the other shows how they in fact *survive*.

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We can perhaps illustrate this difference in the meanings of spontaneous order by comparing a market order with a legal order. Now the invisible hand explanation of the emergence of a market order is highly plausible because there is a mechanism, the price system, to bring about the requisite co-ordination.

However, it is not obviously the case that there is an equivalent mechanism to produce that legal and political order which is required for the co-ordination of individual actions. Thus the legal system that a community has may have *survived* yet not necessarily be conducive to the hypothetical order of classical liberalism. Evolutionary undesigned processes may very well produce dead-ends, and the escape from these dead-ends would involve more expansive use of reason than that conventionally associated with the doctrine of spontaneous order.

[A section on the intellectual origins of the theory of spontaneous order has been omitted because of length]

F.A. HAYEK

Of all the twentieth-century theorists of spontaneous order, Friedrich A. Hayek (b. 1899) has contributed most to the intellectual reproduction of Adam Smith's vision of a self-correcting social order which requires little direction and control. Throughout the great variety of his works [46] he has stressed the importance of spontaneous processes and the impossibility of predicting the future growth of a social order. The whole of his social philosophy may be described as an assault on the exaggerated claims made for ‘reason’ and a justification for the view that we must adopt an attitude of humility towards natural processes and “submit to conventions which are not the result of intelligent design, whose justification in the particular instant may not be recognizable, and which will. . . often appear unintelligible and irrational.”[47]

While Hayek has been a rigorous critic of ‘scientism,’ the belief that the methods of the physical sciences can be readily applied to the study of society, with their concomitant advantages of prediction and control, he does not deny that a social system is governed by ‘laws.’ There are, for example, laws of economics; these consist of, to use Lord Robbins’ phrase, “those necessities to which human action is subject.” In Hayek's opinion, many of the mistakes of rationalist planning stem from attempts to resist the operation of the basic principles of scarcity, supply and demand and so on, and well-established laws of human behavior. A genuine social science, then, would

describe how men adjust to certain inevitable laws and stress how little they can, or need to, control their societies.

KNOWLEDGE AND SOCIETY

In his description of a self-regulating system Hayek's major achievement has been to show that the advantages of decentralized decision-making in a market stem from the fact that this is the only device that man has discovered for coping with the universal facts of ignorance and uncertainty. It is because the social world does not consist of physical objects governed by simple laws of causality, but is a 'kaleidic' world inhabited by individuals with minds, whose the inner recesses are inaccessible to the external observer, that knowledge is not 'fixed' and available to a single person or institution.[48]

Co-ordinating Dispersed Knowledge: Rationale for Market & Liberty

The problem of knowledge arises because the 'facts' of a social and economic system are dispersed throughout the minds of thousands, possibly millions of actors; therefore this knowledge has to be co-ordinated if we are to exploit it for the benefit of man. This division of knowledge, which characterizes any social process with a degree of complexity, is, in Hayek's opinion, as important as the division of labor as a mechanism to explain progress; the co-ordination of this diffused knowledge via a market process allows us to utilize a much greater amount of knowledge than under known alternative systems. Thus, whereas Adam Smith and his successors saw the market and law as co-ordinating the *self-interested* actions of agents so as to produce an unintended beneficial outcome, Hayek speaks of the co-ordination of the actions of necessarily *ignorant* people. Thus the theory of spontaneous order does not depend for its truth on the so-called 'egoistic' behavior assumptions of traditional economic theory because there remain universal co-ordination problems whether people are selfish or altruistic in their impulses. Nevertheless, one should not ignore the importance of 'vulgar' motivations in the economic nexus; the interdependent parts of an economic system are normally held together by self-interest.

The justification for individual liberty is then largely instrumental in that the case for freedom "rests chiefly on the recognition of the inevitable ignorance of all of us concerning a great many of the factors on which the achievement of our ends and welfare depends." [49] It is not that the theory of spontaneous order precludes planning as such; it is that only planning by individuals in decentralized markets will tend towards an optimal use of knowledge. The central planner has only that knowledge available to him, which is less than that which is co-ordinated among all the agents in a market process. Furthermore, because the future is unknowable, a system that relies on liberty allows for the accidental and spontaneous. Hayek's main objection to the rationalist theory of liberty is that the rationalist associates the growth of knowledge with predictability and control; but those things which can be predicted and controlled comprise only a small part of social and economic experience.

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In Hayek's epistemology, *scientific* knowledge of society is knowledge of spontaneously formed orders: the knowledge that we do have of *made* orders cannot be genuine scientific knowledge. Thus much of contemporary sociology and political science is not scientific knowledge but rather contemporary history because those subjects deal with phenomena which are the product of will and intention: the only social phenomena which are explicable by scientific, causal-genetic laws are markets and legal systems.

Ambiguity in Explaining Legal Orders: Spontaneous Order vs. Relativistic Evolution

It is my intention to show that while Hayek's attempt to explain the spontaneous order of the market is largely successful, and indeed contains some of the

most brilliant insights into the nature of economic processes since Adam Smith, his attempt to account for the legal order in similar terms is less successful. This is largely because he blends two subtly different types of explanation: one concerned with the formation of spontaneous orders, and one concerned with the evolution of rules and institutions by natural selection. Hayek himself speaks of the ‘twin ideas’ of evolution and of the spontaneous formation of an order without indicating that there might be an important difference between the two. But the emphasis on evolution and the *cultural transmission* of rules and practices introduces a note of historical relativism which does not always harmonize with the universalistic liberal rationalism characterizing his explanation of the formation of economic orders.

THE FREE EXCHANGE SYSTEM

‘Catallaxy’ vs. ‘Economy’ Market Coordination vs. Neoclassical Equilibrium

“A catallaxy is a network of many firms and households and has no specific purpose of its own: it is that which results naturally from the interaction of firms and households through the exchange process”

The word that Hayek uses to describe a spontaneous market order is *catallaxy*; and a *catallaxy* is contrasted with an *economy*. An economy is a social practice defined in terms of the pursuit of a ‘unitary hierarchy of ends,’ where knowledge of how to achieve these ends is given. A single firm (or a household) is an economy and may be evaluated with the methods of an engineering type of science for its success in achieving prescribed goals, or common purposes. However, a *catallaxy* is a network of many firms and households and has no specific purpose of its own: it is that which results naturally from the interaction of firms and households through the exchange process: “the order of the market rests not on common

purposes but on reciprocity; that is, on the reconciliation of different purposes for the mutual benefit of the participants.”[50]

According to Hayek, the mistake of orthodox neoclassical theory is to treat a *catallaxy* as if it were an economy. This is because of the neoclassical emphasis on static equilibrium. This is an example of rationalism because it is assumed that an ‘efficient’ economic order, in the conventional sense of there being a state of affairs in which it is impossible to switch a resource from one use to another and receive a net benefit, can be designed without a market process to signal information about tastes, costs, and so on. However, this assumes perfect information, whereas the real world is characterized by ignorance, change, and uncertainty, so that knowledge cannot be ‘objectified’ and made to serve given ends. All we can expect is a tendency towards equilibrium as the actions of individuals are co-ordinated through the mechanism of prices. Thus Hayek extends subjectivism beyond the theory of value to the theory of market process.

This theory, that there is a tendency to equilibrium in a decentralized exchange system is of course an empirical theory, which may be falsified. It is logically possible that there may be such endogenous ‘shocks’ to the system that the plans of the participants may not harmonize. Indeed, there are extreme ‘subjectivists’ who do not merely reject the neoclassical orthodoxy concerning static equilibrium, but also suggest that, because of the divergence of ‘expectations,’ future profitable opportunities may not be exploited so that there is not even a tendency for the actions of economic agents to be co-ordinated. In the work of G.L.S. Shackle and Ludwig Lachmann there is the implication that the spontaneous emergence of an *order* may be only a chance phenomenon, rather than a theoretical property of an interdependent economic system. In other words, the market does not co-ordinate expectations in the way that it co-ordinates knowledge.[51] In Hayek's early work on the theory of market process, his main concern was with the disequilibrating effect of certain exogenous factors, such as governmental control of money, which dis-coordinated the actions of economic agents; he did not consider seriously the possibility of the presence of ignorance and uncertainty producing spontaneous disorder. Further, although Hayek presented his theory as an empirical one, he did not indicate under what circumstances it might be falsified. The assumption was

that a *catallaxy* was tending towards equilibrium rather than being moved away by endogenous factors.

Co-ordinating Market Knowledge: Competition & Entrepreneurship

However, it should be argued that there are certain identifiable causal factors at work which bring about this tendency, namely *competition* and *entrepreneurship*; and here, Hayek's important suggestions have been taken up by other writers.[52] His argument is that in the standard general equilibrium model competition does not exist, since, if there is an equilibrium, competition has ceased and opportunities for further trade are exhausted. What is not considered in the general equilibrium model is how this stable state of affairs comes about, or what mechanisms produced this optimum. Hayek's theory maintains that in an uncertain world, the 'discovery procedure' of competition spontaneously co-ordinates decentralized information and thus brings about a tendency towards equilibrium.[53] That array of 'correct' prices proposed by orthodox theory is an illusion; in reality prices are always to some extent 'incorrect' and therefore always suggestive of some reallocation of resources through the competitive process.

It is here that the role of the entrepreneur becomes important because the co-ordination process depends upon the existence of entrepreneurship as a special activity. The concept of entrepreneurship can perhaps be better explained by reference to 'prediction.' Since the general equilibrium model assumes knowledge of tastes, costs, and so on, the implication is that it is possible to predict mechanically what an efficient allocation of resources would be. If this were so, then entrepreneurship would be redundant.

However, in a world of uncertainty, where the future is unknowable, a predictable outcome is an epistemological absurdity. The entrepreneur, albeit guided by self-interest, accidentally plays a socially beneficial role in co-ordinating economic knowledge to produce an outcome which *looks as if* it had been designed and predicted by an omniscient legislator, but clearly could not have been.[54]

In this view of a competitive process such market imperfections as monopoly are not therefore aberrations which can be legislated away so as to eliminate an alleged 'welfare loss' but may well be necessary elements in the emergence of a spontaneous

order. It may be the case that the monopoly reflects superior efficiency, or that without the prospect of monopoly gains a particular good would not be produced at all. In these cases there *is* entrepreneurial activity. In any event, as long as there are no governmental barriers to entry the monopolist operates under some constraint so that rather than eliminate monopoly by law and artificially create some abstract concept of 'perfect competition,' it is better to let natural competitive processes operate. It is Hayek's claim that 'natural' monopolies are extremely rare, and that most monopolies are the product of deliberate government intervention; where they do exist, the market itself is a natural process which generates its own corrective devices.

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The most important feature of the price system is that it economizes on knowledge. Each participant has to know little of the whole system for the co-ordination to be successful since its signals “enable individual producers to watch merely the movement of a few pointers, as an engineer might watch the hands of a few dials, in order to adjust their activities to changes of which they may never know more than is reflected in the price movement.”[55]

Disruptions of Catallaxy

How then does Hayek explain the breakdowns of this *economical* order? In short, he maintains that most of the disorder in the market system that we experience is

a result of mistaken interventionist measures which distort natural self-correcting processes that are at work in the system. Thus the theoretical study of economic processes must emphasize those institutional structures which are disruptive of a spontaneous order. Later, of course, Hayek was to develop a theory of society which suggests how dis-coordinating institutions may be rectified, but in his writings as an economist he took institutions as given and made certain economic inferences from them. In this sense only is his economic theory independent of his general social theory.

“Throughout his career as a pure economist the institutional factor which has concerned Hayek most is governmental control of the monetary instrument. It is this that has generated economic disorder and dis-coordination by distorting the system of relative prices which would otherwise induce economic actors to produce a stable order.”

Throughout his career as a pure economist the institutional factor which has concerned Hayek most is governmental control of the monetary instrument. It is this that has generated economic *disorder* and dis-coordination by distorting the system of relative prices which would otherwise induce economic actors to produce a stable order. Furthermore, arbitrary privileges granted to trade unions by statute law suppress the natural functioning of the labor market so that resources are misallocated and involuntary unemployment generated. Before looking at these types of disorder, however, we should give some attention to that spontaneous *disorder* that Hayek himself admits may be produced by a market subject to no controls.

This occurs in the now familiar areas of public goods and externalities. These areas were little discussed at the time Hayek wrote his pioneering essays on the theory of spontaneous order:[56] He has, however, always argued, against the claims of anarcho-capitalists, that the market cannot spontaneously

produce a police and defense system, and other ‘public goods’ which, according to public goods theory assumptions, it would pay no individual economic actors to supply. In the logically similar area of ‘external bads,’ i.e. where each individual actor in the market has every incentive to impose external costs on the community, as in the case of pollution, Hayek agrees that there may be a role for collective action.

One familiar way of preventing this latter sort of spontaneous disorder is to specify a set of appropriate property rights so that any external harm falls on an individual property holder who can then sue the instigator of the harm for damages. In this way external ‘bads’ might be internalized. While this approach is not antithetical to the Hayekian system it does imply an activist role for some authority in determining new property rules and the *deliberate* agreement of actors to follow such rules. In this, and other areas, Hayek places (in the opinion of many critics) too much reliance on the *evolution* of appropriate property rules for the competitive process:[57] and this is a consequence of his refusal to consider the possibility that in some areas reason may improve on natural processes.

Austrian Perspective on Intervention: Dis-coordination of Economic Knowledge

The kind of disorder, however, to which Hayek has contributed much illumination is that brought about by government intervention in a *catallaxy* at the ‘macro’ level. Of course Hayek has never recognized a macroeconomic theory which is not reducible to individual volitions (holistic magnitudes are ‘fictions,’ they do not display irreducible regularities) but nevertheless his inquiries into the trade cycle focused on the behavior of a *catallaxy* as a whole.[58] Most of his economic theory addresses those who deny the basic proposition that an unhampered market economy (or *catallaxy*) tends towards the full employment of all resources. The most notorious of these theories is Keynesian macroeconomics, and it is to this that Hayekian economics is normally addressed, although he formulated his theory of money and the trade cycle before the publication of Keynes’ *General Theory*.

In the familiar Austrian theory of the trade cycle, disequilibrium and the dis-coordination of economic knowledge is a function of misleading signals being put out to market transactors by the monetary system. An automatic co-ordination of the intentions of savers and

investors, which would produce more or less full employment of all resources, is systematically disrupted by manipulated money, which leads to misallocation and therefore painful periods of readjustment. What happens is that under the fractional-reserve banking system, increased credit lowers the rate of interest on the money market below its 'natural' rate (i.e., the rate determined by the time-preferences of individuals) so that extra investments are made at longer stages of production.

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In Austrian theory the structure of production[59] consists of a series of integrated stages with immediate consumption goods located at the nearest stages and capital goods at the farthest. This 'order' is fundamentally stable if the investment at the farthest stages are warranted by the current consumption-savings ratio of the public, since, then, savings will make available those complementary capital goods which are required to complete the structure of production. However, under the fractional-reserve banking system the structure is unstable. The long-term investments, in this system, are *malinvestments*, brought about by cheaper credit and not by a lowering of time-preferences by the public. Since individuals are consuming at the same rate as before the credit injection begins, extra earnings of labor factors will be spent on consumer goods and therefore cause a switch back to the nearest stages to meet this new demand; and therefore a shrinking of the capital structure occurs. Thus there will be temporary unemployment in the remote stages. The resulting recession must be endured while normal market processes liquidate the malinvestments brought about by misleading price signals.

While this is the standard version of the theory, the particular form in which the disorder takes place will vary according to different institutional structures. In

the 1930s it was increased bank credit that produced the cycle and its effect was visible in the form of unemployment in investment goods industries. In the contemporary world, characterized by massive government intervention, the misallocation is much more diffused throughout the whole system.[60] Also, today the natural readjustment process may be slower, in Britain especially, because welfare legislation, union privileges, and housing policy have all combined to increase the immobility of labor.

Hayek on Monetary Disorder

In all this, the instability of a *catallactic* process is a function of the 'non-neutrality' of money. Since increases in credit do not affect all prices in a uniform manner (which is the implication of the Walrasian general equilibrium theory), disorder must occur under the orthodox banking systems of capitalist economies because changes in relative prices mislead market transactors. The question is whether such *disorder* is a necessary part of a *catallaxy* or whether it is always brought about by some exogenous agency.

Now Hayek has described money as a kind of 'loose joint'[61] in a process which in other respects showed an automatic tendency towards equilibrium. The fractional-reserve system, while its elasticity of credit caused misleading price signals, had itself developed spontaneously, and therefore Hayek, in the 1930s, claimed that its abolition and replacement by a 100 per cent reserve system would create even more problems. All that was required for the self-regulating processes to work was something like the Gold Standard (or fixed rates of exchange) and the withdrawal of government from the economy: this would mitigate, if not entirely eliminate, the effects of the cycle. In practice, it was government mismanagement of the currency that caused severe maladjustment of the *catallaxy*.

Hayek gave no suggestion at this time that government should lose its monopoly over legal tender. Rather he claimed that the disequilibrating effects of this could be mitigated by institutional procedures. In recent years, however, Hayek has pioneered the idea that complete removal of government's monopoly over money is required and that competition between rival currencies, issued by banks and governments, would spontaneously generate monetary stability.[62] The curious feature of this proposal is its contrast with previous theorists of spontaneous economic order who

had argued that the removal of government from money would produce a commodity-based money (indeed, it was a fundamental feature of the monetary theory of Ludwig von Mises that the value of a money device could ultimately be traced back to its value in use). Hayek, however, appears to think that competition between paper currencies will produce stability. He is skeptical of gold becoming usable again—for the fallacious reason, according to orthodox theory, that “there is just not enough gold about”—and makes the constructivistic proposal that countries should mutually bind themselves by formal treaty not to impede the free use of currencies issued by other countries or banks. [63]

“Hayek has pioneered the idea that complete removal of government's monopoly over money is required and that competition between rival currencies, issued by banks and governments, would spontaneously generate monetary stability.”

Irrespective of the details of Hayek's proposed solution to the problems caused by monetary disorder, his persistent argument, over a period exceeding fifty years, that government control of money produces never-ending inflation and a consequent disruption of economic order, has been amply borne out by events. If his social science had been limited to this alone it would constitute a major achievement.

Notes

[For a full citation of books quoted in these notes see the Bibliography at <oll.libertyfund.org/title/1305/100453>]

[1] F.A. Hayek, *Law, Legislation and Liberty*, vol. I, *Rules and Order*, (1973), pp. 8–11; vol. III, *The Political Order of a Free People*, (1979), p. xii. It is in the latter that Hayek uses the word ‘constructivistic’ rather than the more familiar ‘constructivist.’

[2] See Hayek's essay, “The Results of Human Action but not of Human Design,” in *Studies in Philosophy: Politics and Economics* (London: Routledge and Kegan Paul, 1967), pp. 96–105; see also the important article by Edna Ullman-Margalit, “Invisible Hand Explanations,” in *Synthese* 39 (1978): 263–291.

[3] Adam Smith, *The Wealth of Nations*, R.H. Campbell and A.S. Skinner (eds.) p. 456. The reference to the ‘invisible hand’ occurs also in Smith's *Theory of Moral Sentiments*, D.D. Raphael and A. Macfie (eds.), p. 58.

[4] Hayek, “Principles of a Liberal Social Order,” in *Studies in Philosophy, Politics and Society*, p. 167. The only comprehensive treatment of contemporary social and economic problems from a Hayekian standpoint is Thomas Sowell's *Knowledge and Decisions* (1980).

[5] Adam Smith, *The Wealth of Nations*, p. 456.

[6] See Edna Ullman-Margalit, “Invisible Hand Explanations,” pp. 282–286.

[46] See following *Bibliography* for a comprehensive list of Hayek's major works.

[47] Hayek “Individualism: True and False,” in *Individualism and Economic Order*, p. 23.

[48] See especially Hayek's *The Constitution of Liberty* (1960), chapter 2.

[49] Hayek, *The Constitution of Liberty*, p. 29.

[50] Hayek, *Law, Legislation and Liberty*, vol. II, *The Mirage of Social Justice*, pp. 109–110.

[51] See Ludwig Lachmann, “From Mises to Schackle,” *Journal of Economic Literature* 14 (1976): 54–62. For a sophisticated critique of the extreme ‘subjectivists,’ see G.P. O'Driscoll, Jr., “Spontaneous Order and the Co-ordination of Economic Activities,” in Louis M. Spadaro (ed.), *New Directions in Austrian Economics*, pp. 111–142.

[52] Hayek's views are contained in the following essays, “The Use of Knowledge in Society,” and “The Meaning of Competition,” at pp. 77–91 and 91–106,

respectively, in *Individualism and Economic Order*. Also, Hayek's theory of the competitive process emerged from his critique of those socialists who tried to use the neoclassical equilibrium as a model for a socialist economy without private property and a decentralized market. See Hayek's three essays on "Socialist Calculation," in *Individualism and Economic Order*, pp. 119–208. Israel Kirzner has produced a sophisticated version of Hayek's pioneering ideas in *Competition and Entrepreneurship*. See also S.C. Littlechild, *The Fallacy of the Mixed Economy*.

[53] See Hayek's "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas*, pp. 179–90.

[54] Hayek, "The Use of Knowledge in Society," in *Individualism and Economic Order*, p. 86.

[55] Hayek, "The Use of Knowledge in Society," in *Individualism and Economic Order*, p. 87.

[56] For Hayek's recent thoughts on these topics, see *Law, Legislation and Liberty*, vol. III, *The Political Order of a Free People*, chapter 14.

[57] Hayek, *Constitution of Liberty*, p. 365.

[58] For expositions of the Austrian theory of the trade cycle see the following: F.A. Hayek, *Prices and Production* (2nd edition); Hayek, *Monetary Theory and the Trade Cycle*; G. Haberler, *Prosperity and Depression*; and G. O'Driscoll, *Economics as a Co-ordination Problem*.

[59] See Hayek's *Prices and Production* (2nd edition), pp. 34–42.

[60] See "The Campaign Against Keynesian Inflation," in Hayek's *New Studies in Philosophy, Politics, Economics and the History of Ideas*, p. 212.

[61] Hayek, *The Pure Theory of Capital*, p. 408.

[62] First suggested in 1976; see Hayek's *The Denationalisation of Money* (2nd edition).

[63] Hayek, *The Denationalisation of Money* (2nd edition), p. 19.

Further Information

SOURCE

The edition used for this extract: Norman Barry, "Bibliographical Essay: The Tradition of Spontaneous Order" in *Literature of Liberty: A Review of Contemporary Liberal Thought*, Summer 1982, vol. 5, No. 2, pp. 7-58. <oll.libertyfund.org/title/1303/100682>. This extract includes the Introduction and the section dealing with Hayek's theory of spontaneous orders in the economic sphere.

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FURTHER READING

Other works by F.A. Hayek (1899-1992) <oll.libertyfund.org/person/52>

School of Thought: Austrian School of Economics <oll.libertyfund.org/collection/8>

Topic: Spontaneous Order <oll.libertyfund.org/collection/104>.

“The distinctive principle of Western social philosophy is individualism. It aims at the creation of a sphere in which the individual is free to think, to choose, and to act without being restrained by the interference of the social apparatus of coercion and oppression, the State.”
[Ludwig von Mises, “Liberty and Property” (1958)]



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