

Fachbereich Wirtschaftswissenschaft

**A Reconstruction and Critique of Hayek's Theory of
Free Market Economy**

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0. Introduction

It is now a widely discussed question whether there has been a discontinuity in Hayek's works. Another, but related, problem is whether Hayekian arguments are consistent in themselves or there are some tensions or even contradictions between parts of his arguments. A third related question may be that in what respect there lies a discontinuity and when it happened, and what the substance and possible causes of tensions are.

In his early academic career Hayek was a conventional and 'technical' economist as he himself described.¹ From the late 1920s till the early 1940s his main field of interest was theory of price, money, business cycle and capital.² His early work was concerned with³: modification of the concept of static equilibrium to accommodate time and expectation and development of a monetary business cycle theory that criticizes quantity theory of money which does not deal with change in production structure and relative prices as well as expansionist policy of 'easy money' (or 'forced saving'). Furthermore, these themes are closely interrelated. Hayek acknowledged that within the framework of static equilibrium there can be no business cycle. For him the main cause of business cycle is the deviation of money rate of interest from the natural rate⁴, which he, first of all, ascribed to expansionist policy of the central bank.⁵ When the money rate drops below the natural rate (or equilibrium rate), entrepreneurs 'deepen' their capital structure as they shift to more capital-intensive production (more 'roundaboutness' of production or the lengthening of the period of production) which is more lucrative under the circumstance. This leads successively to change in relative prices of consumption goods and capital goods and in labor costs in both sectors. With the gradual change of production structure from the lower

¹ For an overview of Hayek's whole research program see Birner (1994) O'Brien (1998).

² His major works in this period are (or are contained in) *Money, Capital and Fluctuations: Early Essays* (Hayek 1984); *Monetary Theory and the Trade Cycle* (Hayek 1933); *Prices and Production* (1935); *Profits, Interest and Investment* (Hayek 1939); *The Pure Theory of Capital* (1941).

³ On Hayek's economic theory in this field see Desai (1982), Garrison (1986), Haberler (1986), Caldwell (1988, pp. 516-516-525), Colonna (1990), Dostaler (1994), Foss (1995), Witt (1997, pp. 45-51).

⁴ Hayek borrowed this distinction from Wicksell. Cf. Desai (1982, pp. 152ff.); Colonna (1990, pp. 50ff.).

⁵ Trautwein (1994, p. 76 and p. 81, n. 2) points to some ambivalence in Hayek's explanation of the causes of deviations of the market rate from the equilibrium rate.

order to higher order, meaning increasing productivity must be the long-term perspective of the capitalist economy, he argued that this long-term path is not afflicted by serious disturbances of equilibrium of the economy⁶ only on the basis of ‘voluntary saving’⁷. In other words, according to Hayek, “capital accumulation generated by ‘credit expansion’ cannot be *permanent*” (Colonna 1990, p. 58).

By introducing money Hayek attempted to construct a theory of business cycle which cannot be explained by static theory⁸ which is only applicable to barter economy. But as Colonna (1990, pp. 63-4) argues:

“Although Hayek recognizes that a ‘monetary economy’ is different from a barter economy, and although his theory implies that a peculiar feature of a monetary economy is that it is almost always in ‘disequilibrium’ (while a barter economy is almost always in equilibrium), still in his theory the role of money is the traditional and very limited one of ‘disturbing’ the normal course of events in the short run and of being ‘neutral’ in the long run. The ‘normal’ course of events is the one dictated by the barter economy general equilibrium theory.”⁹

In spite of his critique of static equilibrium analysis, Hayek was convinced that there is a inherent tendency toward equilibrium if not disturbed by exogenous factors, in this case money.¹⁰ Furthermore, he was critical of countercyclical measures of gov-

⁶ Cf. Garrison (1986, pp. 441f.): “It is the shifting of resources between consumption and investment activities – and between the different stages of the production process – in response to changing intertemporal consumption preferences [between current consumption and saving] that allows the economy to achieve intertemporal coordination. And it is the similar shifting of resources in response to monetary manipulation that constitutes intertemporal discoordination.”

⁷ It is interesting to note that in his last work (Hayek 1988, p. 67) Hayek counted saving, besides private property and contract, to moral traditions which are requisite for the emergence and maintenance of extended order of capitalism. See below.

⁸ Cf. Desai (1982, p. 152): according to Hayek, “Since a Walrasian economy cannot exhibit disequilibrium, observed disequilibrium must arise from a factor not in the Walrasian economy, i.e. money. The introduction of money opens out the ‘closed’ Walrasian system and permits cycles to occur.”

⁹ Dostaler (1994, p. 163) argues to the similar effect: “Hayek states clearly, in his early work, that money plays an essential part in the economy, that a monetary economy is quite different from a real-exchange economy But he then turns back to a conception of money considered, not as an integral part of the economy, but as a veil, or as the oil of the engine, according to Hume’s vision. Money, considered as an exogenous element, is thus the villain, responsible in the last resort for crises and cycles.”

¹⁰ As Colonna (1990, p. 64) remarks: “Hayek’s theory is strongly based on the assumption that, whatever the disturbing factors may be, in a free market economy the inherent tendency towards equilibrium finally will prevail, or at least is always at work. More difficult problems arise only in the case of money. His original contribution must be envisaged under the assumption that *only* money, when it is introduced into the analysis, allows an account of a disequilibrium situation ‘different in character’ from the adjustment problems raised by any other real factor.”

ernment and argued that one must let crisis run its course because that is the way how the economy returns to equilibrium whose position, according to Hayek, is determined only by real factors.

A most conspicuous break in Hayek's career is his turning away from 'technical' economics to political philosophy in a broad sense, although he retained his self-concept as an economist. Bruce Caldwell (1988) explained 'Hayek's transformation' as a result of Hayek's disappointment and break with neoclassical notion of (general) equilibrium. According to Caldwell (1988, p. 515)¹¹,

"Hayek's transformation refers to his movement away from the study of technical economics. It took place as Hayek came to realize the magnitude of the limitations confronting the major tool of economic analysis, the equilibrium construct. Though he was long aware of certain deficiencies in equilibrium analysis, its inability to shed any light on the problem of coordination was decisive. In his early work, Hayek had virtually defined doing economics as doing equilibrium theory. Having discovered that equilibrium theory was incapable of solving the coordination problem, it was only natural that Hayek should turn away from economic theory in search of new solutions."

This does not mean, however, that Hayek adopted, instead, the course of 'disequilibrium economics' in his later works. Whether he did not give up equilibrium concept altogether but maintained an equilibrium concept throughout his entire work, however different from the neoclassical notion, is a controversial issue even among Austrian economists (cf. Vaughn 1999). Most importantly, his insistence on the empirical tendency to equilibrium as a basis for economics is, although he did not repeat this explicitly in his later work, very significant for interpretation of Hayek's work and understanding of his policy stance, as I shall demonstrate below.

¹¹ Foss (1995, p. 349) sees the nature of Hayek's transformation similarly: "Finding traditional economics unable to deliver a satisfying answer (to the problem of dispersed knowledge and its coordination), Hayek turned to political philosophy, jurisprudence, and other sources, discovering a number of useful clues in classical liberal scholarship, such as the emphasis on the selection of those cultural practices that stimulated the coordinating forces of society." This kind of transformation is also remarked by Colonna (1990, p. 43): "After ten years of intense work devoted to clarifying, improving and defending the theory originally put forward in *Prices and Production* (1931), the early 1940s mark a switch of Hayek's own work from technical economics to a larger research programme including social and political philosophy, methodology, psychology, legislation theory, and history of ideas."

Even if we accept, following Caldwell, that his refusal of neoclassical notion of equilibrium was a decisive turning-point for Hayek, which, as Caldwell argues, was mainly prompted or caused by his participation in the Socialist Calculation Debate (for more see below), the question remains as to what is its impact on his arguments in a wider context¹². What did Hayek achieve, or what did Hayek target with his departure from technical economics, in a narrow sense, and his refusal of neoclassical economics and his turning to a wider range of subjects and disciplines?

I argue that tensions between Hayekian arguments have nothing to do with Hayek's transformation and that they did not coincide, logically or periodically, with it. Hayek came to recognize that economic theory and policy which follows the footsteps of classical liberalism cannot be constructed along the lines of neoclassical economics and within the narrow scope of economics (cf. Hayek 1960, CL, p. 3)¹³. What is peculiar though is that Hayek seems to rely on the results of neoclassical theory when necessary without further substantiation or elaboration.¹⁴

Tensions inherent in Hayekian arguments arise from the contradictions as to how to achieve his aim. Tensions arise from contradictions between reconstruction of market economy at the theoretical on the one hand and at the policy level on the other; and between his rational and evolutionary arguments.

In his effort to substantiate superiority of market economy over socialism or planned economy, he reconstructed theory of market economy on his knowledge argument. His knowledge argument, which is also the basis for his case for liberalism and non-interventionism, is gradually connected with his evolutionary argument. In a sense, his attempt to 'reshape' market economy along the different lines from doctrine of laissez-faire and socialism is associated with theoretically constructing an 'ideal' society in general and 'ideal' market economy in particular (this is implied, when

¹² I would call this 'Hayek after transformation' or 'Hayek's second transformation'. See below Ch. 7.

¹³ "Though I still regard myself as mainly an economist, I have come to feel more and more that the answers to many of the pressing social questions of our time are to be found ultimately in the recognition of principles that lie outside the scope of technical economics or of any single discipline. Though it was from an original concern with problems of economic policy that I started, I have been slowly led to the ambitious and perhaps presumptuous task of approaching them through a comprehensive restatement of the basic principles of a philosophy of freedom" (Hayek 1960, CL, p. 3).

¹⁴ Cf. Eatwell and Milgate (1994).

Hayek spoke of the indispensability and significance of utopia or ideology)(see below Ch. 5): ideal in the sense that society and economy work according to certain desirable principles. To construct these principles was the task Hayek set himself throughout his lifetime.

The problem is that the principles according to which ('ideal') economy and society must work cannot be provided by evolutionary process. Ideas that cherish these principles must prevail in order for this to be possible. However, Hayek did not provide for explanations how the ideas evolve. That is, he did not think that this is either possible or necessary. His theoretical reconstruction of market economy on the basis of his knowledge and evolutionary arguments is just aimed at making public opinion susceptible to the ideas.

The tensions arise from contradictions between his rational (and ordoliberal) arguments and his evolutionary (neoliberal) arguments. The two kinds of arguments, however, exist parallel in Hayek's works from early on (and remain after Hayek's transformation) and thus nothing to do with the problem of discontinuity. Nonetheless, there does exist shift of emphasis from the former to the latter argument in his later work when Hayek systematized his notion of evolution. Thus the most fundamental discontinuity in Hayek's works cannot be strictly periodically determined but rather in the tensions inherent in his work from early on.

I shall demonstrate in the following chapters that Hayek did not entirely overcome equilibrium thinking and that it underlies his theory of spontaneous order and cultural evolution. Nonetheless, some important features distinct from neoclassical economics must be considered, which was neglected by heterodox economics (above all, Old Institutional Economics (OIE)), if one tries to assess the relative merits and shortcomings of Hayekian theory which attempts to criticize neoclassical economics on the one hand and to construct a liberal theory on the other.

I argue that the insights of Polanyian embeddedness deliver the basis for assessing the neoclassical nature in Hayek's theory that remains in spite of his effort to incorporate 'institutional' and evolutionary arguments and serve to demonstrate that ten-

sions inherent in his work can most clearly be pointed out and resolved from the perspective of Polanyian (substantive) embeddedness.

1. Knowledge Dimensions: Equilibrium, Competition, Socialism

Underlying Hayek's theory of market economy was his concern about increasing interventionist tendencies of the 1930s. He has never been satisfied with capitalism as it is, which explains his critique of the doctrine of laissez-faire:

"If we are to judge the potentialities aright, it is necessary to realize that the system under which we live, chocked up with attempts at partial planning and restrictionism, is almost as far from any system of *capitalism which could be rationally advocated* as it is different from any consistent system of planning. It is important to realize in any investigation of the possibilities of planning that it is a fallacy to suppose capitalism as it exists today is the alternative. We are certainly as far from *capitalism in its pure form* as we are from any system of central planning. The world of today is just interventionist chaos" (Hayek 1935a, p. 136; emphasis added).

So, Hayek made attempts to theoretically reconstruct capitalism which could be rationally advocated. To this end, his foremost achievement was his knowledge argument. This argument is closely connected with his critique of neoclassical notion of perfect knowledge and perfect competition and his critique of theory of market socialism. Both critiques are essentially of the same nature.

Equilibrium and knowledge

The Significance of Hayek's '*knowledge argument*' and '*knowledge problem*'¹⁵ throughout his entire work will be demonstrated at various places below.

Its explicit beginning, which Hayek in retrospect also acknowledged, is his seminal essay *Economics and Knowledge* (Hayek 1937)¹⁶:

¹⁵ To prevent possible confusion or misunderstanding I point out in advance that I use two terms (knowledge argument and knowledge problem) differently, which are closely related but must be distinguished in the interpretation of Hayek's theory.

¹⁶ Many commentators take this paper to be the document of the beginning of 'Hayek's transformation'. Cf. Caldwell (1988).

“[T]hough at one time a very pure and narrow economic theorist, I was led from technical economics into all kinds of questions usually regarded as philosophical. When I look back, it seems to have all begun, nearly thirty years ago, with an essay on ‘Economics and Knowledge’ in which I examined what seemed to me some of the central difficulties of pure economic theory. Its main conclusion was that the task of economic theory was to explain how an overall order of economic activity was achieved which utilized a large amount of knowledge which was not concentrated in any one mind but existed only as the separate knowledge of thousands or millions of different individuals. But it was still a long way from this to an adequate insight into the relations between the abstract rules which the individual follows in his actions, and the abstract overall order which is formed as a result of his responding, within the limits imposed upon him by those abstract rules, to the concrete particular circumstances which he encounters. It was only through a re-examination of the age-old concept of freedom under the law, the basic conception of traditional liberalism, and of the problems of the philosophy of law which this raises, that I have reached what now seems to me a tolerably clear picture of the nature of the spontaneous order of which liberal economists have so long been talking” (Hayek 1964, pp. 91f.).

In Hayek’s view, the economist is more likely to be susceptible to this kind of problematic:

“I want to make quite clear ... that the economist can *not* claim special knowledge which qualifies him to co-ordinate the efforts of all the other specialists. What he may claim is that his professional occupation with the prevailing conflicts of aims has made him more aware than others of the fact that no human mind can comprehend all the knowledge which guides the actions of society and of the consequent need for an impersonal mechanism, not dependent on individual human judgments, which will co-ordinate the individual efforts. It is his concern with the impersonal processes of society in which more knowledge is utilized than any one individual or organized group of human beings can possess that puts the economists in constant opposition to the ambitions of other specialists who demand powers of control because they feel that their particular knowledge is not given sufficient consideration” (Hayek 1960, CL, p. 4).

We can gather from his statements that it is Hayek’s knowledge argument which is a junction between his various arguments of his interdisciplinary approach, or more boldly formulated, a leverage which transforms his economic theory into political philosophy of freedom.¹⁷ Therefore, Hayek’s political or social philosophy, which

¹⁷ Referring to his two papers (Hayek 1937; Hayek 1945b) which deal with ‘knowledge problem’ and ‘knowledge argument’ respectively, Hayek (1973, LLL 1, p. 13) himself stated: “The insight into the significance of our institutional ignorance in the economic sphere, and into the methods by which we

accounts for his increasing influence from the 1970s on can be best understood in the contest of his underlying economic theory.¹⁸ This implies that, only through the through examination of his economic theory which is the basis of his wider interdisciplinary approach can one assess the relative merits and shortcomings of his arguments. Two questions arise in this respect. The first is whether Hayek's economic theory is consistent in itself. The second is whether and to what extent Hayek succeeded in the application of his economic theory to his wider political philosophy (or in connecting the former with the latter).¹⁹ I would argue below that Hayek did not complete the task he set himself to his economic theory and he tried to fill this gap with links to various disciplines. This does not mean, however, that unfinished tasks of his economic theory are solved by his wider social and political philosophy but, rather, may mean that unresolved problems are shifted to and fro without being solved by either the former or the latter. This issue can be demonstrated by examining his price theory and the ambiguous nature of the relationship between equilibrium and order (or demarcation of the former from the latter) in his theory.

What Hayek attempted in his *Economics and Knowledge* may be described as a subjectivist reinterpretation of the notion of equilibrium because for him "the tautological propositions of pure equilibrium analysis as such are not directly applicable to the explanation of social relations" (Hayek 1937, p. 35).

have learnt to overcome this obstacle, was in fact the starting point for those ideas which [in Hayek 1973, 1976, 1979] are systematically applied to a much wider field." A major contention in this regard is that "most of the rules of conduct which govern our actions, and most of the institutions which arise out of this regularity, are adaptations to the impossibility of anyone taking conscious account of all the particular facts which enter into the order of society" (Hayek 1973, LLL 1, p. 13). For more on this point see below (Ch. 3).

¹⁸ In his later work Hayek (1976, LLL 2, p. 113) once again put stress on the 'privileged' status of economics and the economist: "The truth is that catallactics [the term which Hayek proposed as an alternative to 'economics' following Richard Whately and Ludwig Mises; cf. *ibid.*, p. 108.] is the science which describes the only overall order that comprehends nearly all mankind, and that the economist is therefore entitled to insist that conduciveness to that order be accepted as a standard by which all particular institutions are judged." Underlying this view is the implication that the economic sphere or economic relations are the predominant one in the overall order of Society, which stands in contradistinction to Polanyian view of embeddedness, with which I shall deal below (Ch. 2).

¹⁹ In my view examination of congruence of Hayek's economic theory with his social and political philosophy is an area which is not yet sufficiently investigated and thus deserves more attention from scholarship on Hayek.

Hayek's definition of 'societal' (in contrast with individual) equilibrium is the compatibility of individual plans or subjective data and/or correspondence between subjective data with external or objective facts.²⁰

The coincidence of subjective data with objective data or facts must be explained by the economists and must not simply be assumed as 'traditional' equilibrium analysis does. Though Hayek doubted pure equilibrium analysis, he did not call into question "the supposed existence of a tendency toward equilibrium" as the only justification for the economists' concern with "the admittedly fictitious state of equilibrium": "It is only by this assertion that such a tendency exists that economics ceases to be an exercise in pure logic and becomes an empirical science" (Hayek 1937, p. 44). Applied to the concept of equilibrium this can only mean that

"under certain conditions the knowledge and intentions of the different members of society are supposed to come more and more into agreement or, to put the same thing in less general and less exact but more concrete terms, that the expectations of the people and particularly of the entrepreneurs will become more and more correct" (ibid, p. 45).

Although Hayek did not explicitly mention this 'real' tendency toward equilibrium in his (later) work of political philosophy, it might be seen to be implied when Hayek wrote:

"Just as in biological evolution it may matter less for the preservation of the species if no provision is made to avoid certain lethal but rare effects than if a frequently occurring kind of event doing only slightly damage to the individual is avoided, so the rules of conduct that have emerged from the process of social evolution may often be adequate to prevent frequent causes of minor disturbances of the social order but not rare causes of its total disruption" (Hayek 1976, LLL 2, pp. 21-2).

Hayek spoke of disturbance of and return to equilibrium in various contexts as if he had fully explained that there were a real tendency to equilibrium, which he did not.²¹

²⁰ It is somewhat confusing that Hayek later included in objective facts also plans of other individuals: cf. Hayek 1946, p. 93.

²¹ Cf. Hayek (1973, LLL 1, pp. 62-3): "With respect to policy, the methodological insight that in the case of complex spontaneous orders we will never be able to determine more than the general princi-

In a sense, Hayek's notion of order can be understood as the loosening (or relativization) of the (neoclassical) notion of equilibrium. However, he did not make clear how the former is related with his subjectivist societal equilibrium.

Hayek did not explicitly deal with the relation between his conception of equilibrium and order, but the affinity between them cannot be overlooked.

By order Hayek described

“a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct. It is clear that every society must in this sense possess an order and that such an order will often exist without having been deliberately created” (Hayek 1973, LLL 1, p. 36; emphasis in the original).

If every society possesses an order or an order is approached in a high degree (cf. Hayek 1968, p. 184), whereas an economic equilibrium never really exists, what is a distinctive feature of the Great Society? Is it an ideal type or a real type?²²

This constitutes a tension between liberal and conservative elements in Hayek's theory²³: between Hayek's critique of capitalism as it is and his subsequent reconstruction of capitalism as it ought to be on the one hand, and Hayek's justification of capitalism as such as a liberal order: Great Society and concomitant capitalism which guarantee individual liberty of using their own knowledge while pursuing their individual goals, through which process civilization is made possible, which thus embodies far more knowledge and experience than any single mind can possess. This is for Hayek only possible where traditions are not questioned but accepted:

ples on which they operate or to predict the particular changes that any even in the environment will bring about, has far-reaching consequences. It means that where we rely on spontaneous ordering forces we shall often not be able to foresee the particular changes by which the necessary adaptation to altered external circumstances will be brought about, and sometimes perhaps not even be able to conceive in what manner the restoration of a disturbed 'equilibrium' or 'balance' can be accomplished. This ignorance of how the mechanism of the spontaneous order will solve such a 'problem' which we know must be solved somehow if the overall order is not to disintegrate, often produces a panic-like alarm and the demand for government action for the restoration of the disturbed balance. ... The economist, from the very nature of his schematic picture of the spontaneous order, could counter such apprehension only by the confident assertion that the required new balance would establish itself somehow if we did not interfere with the spontaneous forces; but, as he is usually unable to predict precisely how this would happen, his assertions were not very convincing.”

²² For more on this point see below (Ch. 6, *accounting for 'failure' of competition*).

²³ For more on this point see below (Ch. 5).

“Our civilization depends, not only for its origin but also for its preservation, on what can be precisely described only the extended order of human cooperation, an order more commonly, if somewhat misleadingly, known as capitalism. To understand our civilization, one must appreciate that the extended order resulted not from human design or intention but spontaneously: it arose from unintentionally conforming to certain tradition and largely *moral* practices, many of which men tend to dislike, whose significance they usually fail to understand, whose validity they cannot [and need not] prove, and which have nonetheless fairly rapidly spread by means of an evolutionary selection – the comparative increase of population and wealth – of those groups that happened to follow them. The unwitting, reluctant, even painful adoption of these practices kept these groups together, increased their access to valuable information of all sorts, and enabled them to be ‘fruitful, and multiply, and replenish the earth, and subdue it’ (*Genesis* I: 28). This process is perhaps the least appreciated facet of human evolution” (Hayek 1989, FC, p. 6).

This is perhaps the best summary of his social philosophy which underlies his whole work after ‘Transformation’. It is significant that Hayek ascribes the origin and preservation of our civilization to capitalism: capitalism is the foundation of the civilization. The inverse of the argument is that socialism undermines and destroys our civilization. Extended order, alias “capitalism”, is, in turn, due to unintentional (and uncritical as will be shown below) conformation to certain traditions and morals. This is combined with his evolutionary arguments. That Hayek’s arguments took a conservative turn in his later work with his increasing adoption of evolutionary arguments is not quite right (cf. Vanberg 1994b): it would be more accurate to say that they were increasingly applied in order to underpin and corroborate his conservatism already existing in his early work.²⁴ Probably Hayek was conscious of this, which prompted him to explicitly distinguish his arguments from conservatism in *Why I Am Not a Conservative* (Hayek 1960, CL, pp. 397-411).²⁵

²⁴ For more on this point see below (Ch. 5).

²⁵ One is strongly reminded of Keynes’ speech *Am I A Liberal?* (Keynes 1925). While contending that “the positive argument for being a Liberal, is at present, very weak (ibid, p. 298), Keynes argues that “the transition from economic anarchy to a régime which deliberately aims at controlling and directing economic forces in the interests of social justice and social stability, will present enormous difficulties both technical and political. I suggest, nevertheless, that the true destiny of New Liberalism is to seek their solution” (ibid, p. 305). He argues further that “in the economic fields ... we must find new policies and instruments to adapt and control the working of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice” (ibid, p. 306). See also Keynes (1926). As I shall show below, Hayek’s understanding of liberalism and of social justice is miles away from that of Keynes.

Hayek's disposition to conservatism was present in his early work and observed by Harrod who also made a very stinging remark on "a certain tendency to dogmatism and exclusiveness" in *Road to Serfdom* (Hayek 1944/1994) that "there is a clear danger that Professor Hayek may let this tendency to dogmatism [and exclusiveness] assume the mastery in his intellectual make-up" (Harrod 1946, p. 435). Dichotomization, which indeed can lend itself to dogmatism, remains characteristic of Hayek's reasoning throughout his work.²⁶

Hayek did not deal with the existence of equilibrium but with the assertion of the existence of a *tendency toward* equilibrium as "an empirical proposition" which is "at least in principle" "capable of verification" since he believed that state of equilibrium never really exists and is therefore "fictitious". In this context, Hayek raised two problems to be clarified: first, "the *conditions* under which this tendency is supposed to exist"; second, "the nature of the process by which individual knowledge is changed" (Hayek 1937, p. 45). The assumption of a perfect market or perfect knowledge made by pure equilibrium analysis did not solve these questions of how the equilibrium comes about for it amounts to "no more than the apparent proof of what is already assumed" (ibid.):

"The statement that, if people know everything, they are in equilibrium is true simply because that is how we define equilibrium. The assumption of a perfect market in this sense is just another way of saying that equilibrium exists but does not get us nearer an explanation of when and how such a state will come about (ibid, p. 46).

Thus, the empirically relevant question of "what happens in the real world" is by what process people acquire the necessary knowledge or "how knowledge is acquired and communicated" (ibid, p. 46).

Hayek's two questions concerning the tendency toward equilibrium can be translated into the question of "what are the concrete hypotheses concerning the conditions under which people are supposed to acquire the relevant knowledge and the process by which they are supposed to acquire it" (ibid, p. 48). However, Hayek did not pur-

²⁶ See below Ch. 4, *constructivist rationalism vs. evolutionary rationalism*.

sue this question further²⁷. Instead he proposed a different, though related, line of question – “how much knowledge and what sort of knowledge the different individuals must possess in order that we may be able to speak of equilibrium” (ibid, p. 50). This is the problem of “division of knowledge”²⁸ which is, for Hayek, “the really central problem of economics as a social science”:

“The problem which we pretend to solve is 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 which could be brought about by deliberate direction only by somebody who possessed the combined knowledge of all those individuals. Experience shows us that something of this sort does happen, since the empirical observation that prices do tend to correspond to costs was the beginning of our science” (ibid, pp. 50f.).

The “central question of all social sciences” is, thus, for Hayek:

“How can the combination of fragments of knowledge existing in different minds bring about results which, if they were to be brought about deliberately, would require a knowledge on the part of the directing mind which no single person can possess?”

What must be showed in this context is that

“the spontaneous actions of individuals will, under conditions which we can define, bring about a distribution of resources which can be understood as if it were made according to a single plan, although nobody has planned it” (ibid, p. 54).

This is the ‘*knowledge problem*’ which arises due to dispersed, incomplete and subjectively-held knowledge at the individual level and which must be solved; or in other words, how bits or fragments of knowledge can be coordinated into a coherent whole and thus best utilized (which enables “division of knowledge”). Hayek’s underlying assumption in this regard is that the knowledge problem is actually solved

~~in one way or another, which amounts to assuming the tendency toward~~

²⁷ Cf. Hayek (1937, p. 48): “I am afraid that I am now getting to a state where it becomes exceedingly difficult to say what exactly are the assumptions on the basis of which we assert that there will be a tendency toward equilibrium and to claim that our analysis has an application to the real world.”

²⁸ For Hayek the problem of the division of knowledge is “quite analogous to, and at least as important as, the problem of the division of labor. But, while the latter has been one of the main subjects of investigation ever since the beginning of our science, the former has been as completely neglected, although it seems to me to be the really central problem of economics as a social science” (Hayek 1937, p. 50).

one way or another, which amounts to assuming the tendency toward equilibrium.²⁹ Hayek's critique of neoclassical notion of equilibrium is that in its framework the knowledge problem is neither solved nor recognized but simply assumed (or defined) away.³⁰ Whereas first his reformulation of societal equilibrium, as compatibility of individual plans (or subjective data) and their correspondence with objective facts, gives rise to the knowledge problem, on the *factual* resolution of which in the real world he needed to offer some *theoretical* explanations.

Instead of clarifying questions regarding the tendency toward equilibrium, Hayek simply stated "on empirical grounds we have reason to believe [it] to exist" (ibid, p. 55). The problem of knowledge which Hayek, in the first instance, raised in the context of the (tendency toward) equilibrium, is now transformed into the question of comparative economic system: to show that (rather than how) the problem is resolved in a market economy, whereas it is not the case in socialism. This becomes clear when Hayek dealt with the problem of knowledge eight years later, again, in his *The Use of Knowledge in Society* (Hayek 1945b). This is the 'emergence' of Hayek's *knowledge argument*. It started as a critique of pure equilibrium analysis and became the basis for his critique of socialism and for his justification of a market economy and human civilization in broader terms beyond (neoclassical) economics. That it is to a large extent effected by his participation in the Socialist Calculation Debate will be dealt with below. However, the change in the nature of his knowledge problem must be recorded: he did not solve the original problem but just transformed it.³¹ More boldly formulated, Hayek's suggestion is that what he did not theoretically solve is in reality solved by decentralized market economy with its price system.

²⁹ This view underlies also Hayek's later formulation of spontaneous order as Boehm (1994, p. 298) states: "large-scale disorder is none of Hayek's concern."

³⁰ Cf. Hayek (1937, p. 44): "The point is that the pure equilibrium analysis is not concerned with the way in which this correspondence is brought about. In the description of an existing state of equilibrium which it provides, it is simply assumed that the subjective data coincide with the objective facts."

³¹ Cf. Desai (1994). For more on this see below.

Use of Knowledge in Society

This time Hayek deals with the knowledge problem explicitly in terms of a “rational economic organization” or “constructing a rational economic order”:

“The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate “given” resources – if “given” is taken to mean given to a single mind which deliberately solves the problem set by these “data.” It is rather a problem of 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. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality” (Hayek 1945b, pp. 77f.).³²

Thus the problem of “utilizing knowledge initially dispersed among all the people” which amounts to the problem of “designing an efficient economic system” cannot be solved by the pure economic analysis and the assumption of perfect knowledge:

“If we possess all the relevant information, if we can start out from a given system of preferences, and if we command complete knowledge of available means, the problem which remains is purely one of logic. That is, the answer to the question of what is the best use of the available means is implicit in our assumptions” (ibid, p. 77).

That this kind of approach cannot provide an answer to the knowledge problem is again that “the “data” from which the economic calculus starts are never for the whole society “given” to a single mind which could work out the implications and can never be so given” (ibid, p. 77).

Thus the knowledge argument in this context delivers a standard of efficiency of different economic systems of central planning versus competition (which is decentralized planning by separate individuals): which system makes fuller use of knowledge possible:

³² Kirzner (1984a, p. 408) suggests to “call *this* knowledge problem “Hayek’s knowledge problem”.”

“This, in turn, depends on whether we are more likely to succeed in putting at the disposal of a single central authority all the knowledge which ought to be used but which is initially dispersed among many different individuals, or in conveying to the individuals such additional knowledge as they need in order to enable them to dovetail their plans with those of others” (ibid, p. 79).

In this connection Hayek differentiates from different kinds of knowledge because the answer to the question of which system is more efficient depends on the “relative importance of different kinds of knowledge” (ibid, pp. 79ff).³³ For Hayek, to deal with “scientific knowledge” (and for that matter “theoretical” or “technical knowledge”), which is relatively easier to collect and convey, is only a “smaller part of the wider problem” relating to “division of knowledge”. Far more important is the problem of coping with division of “unorganized” or “practical knowledge”, that is, “the knowledge of the particular circumstances of time and place”³⁴

With emphasizing that the more important part of knowledge problem must be attributed to the knowledge of the particular circumstances of time and place Hayek stressed the significance and frequency of changes which the ‘planners’ neglected or played down. Since “economic problems arise always and only in consequence of change”, which requires constant alterations and adjustments of plans, central planning which attempts to draw up a comprehensive plan for long periods cannot cope with the problems (Hayek 1945b, p. 81f.). This constitutes an important element of Hayek’s critique of socialism based on central planning³⁵, which I will deal with

³³ For more on this see below Ch. 3, *Hayek and OIE on rules and institutions*.

³⁴ Hayek clarifies its meaning by illustration. See Hayek (1945b, p. 80): “The shipper who earns his living from using otherwise empty or half-filled journeys of tramp-steamers, or the estate agent whose whole knowledge is almost exclusively one of temporary opportunities, or the arbitrageur who gains from local differences of commodity prices – are all performing eminently useful functions based on special knowledge of circumstances of the fleeting moment not known to others”; Hayek (ibid, p. 83): “The continuous flow of goods and services is maintained by constant deliberate adjustments, by new dispositions made every day in the light of circumstances not known the day before, by B stepping in at once when A fails to deliver.”

³⁵ Cf. Hayek (1945b, p. 83): “The sort of knowledge with which I have been concerned is knowledge of the kind which by its nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form ... It follows from this that central planning based on statistical information by its nature cannot take direct account of these circumstances of time and place and that the central planner will have to find some way or other in which the decisions depending on them can be left to the “man on the spot”.”

shortly below, and his justification for a market economy based on decentralized (individual) plans³⁶:

“We need decentralization because only thus can we insure that the knowledge of the particular circumstances of time and place will be promptly used” (Hayek 1945b, p. 84).

In this context the same kind of problem must be solved which Hayek raised but not solved in his *Economics and Knowledge*: how to secure congruence of individual subjective data with objective facts; the ‘relevant’ knowledge individuals must possess in order that equilibrium may prevail (Hayek 1937, pp. 51ff.). That is, how the decentralized plans can be coordinated: the problem of “conveying to the individuals such additional knowledge as they need in order to enable them to dovetail their plans with those of others” or the problem of communicating to [the “man on the spot”] such further information as he needs to fit decisions into the whole pattern of changes of the larger economic system” (Hayek 1937, p. 79 and p. 84). That is, individual plans based on their “limited but intimate knowledge” of the facts of their immediate surroundings must be coordinated into a coherent whole. This is not a solution but rather only another way of raising the same problem:

“Which of the events which happen beyond the horizon of his immediate knowledge are of relevance to his immediate decision, and how much of them need he know?” (Hayek 1945b, p. 84).

Hayek’s answer is: what the individual only need to know in order that he can successfully use his knowledge of particular circumstances is the price³⁷:

³⁶ See Hayek (1945b, p. 83f.): “If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them.”

³⁷ Hayek (1945b, pp. 85f.) attempted to illustrate this as follows: “Assume that somewhere in the world a new opportunity for the use of some raw material, say, tin, has arisen, or that one of the sources of supply of tin has been eliminated. It does not matter for our purpose – and it is significant that it does not matter – which of these two causes has made tin more scarce. All that the users of tin need to know is that some of the tin they used to consume is now more profitably employed elsewhere and that, in consequence, they must economize tin. There is no need for the great majority of them even to know where the more urgent need has arisen, or in favor of what other needs they ought to husband the supply. If only some of them know directly of the new demand, and switch resources over to it, and if the people who are aware of the new gap thus created in turn fill it from still other sources, the effect will rapidly spread throughout the whole economic system and influence not only all the uses of tin but also those of its substitutes and the substitutes of these substitutes, the supply of

“In a system in which the knowledge of the relevant facts is dispersed among people, prices can act to co-ordinate the separate actions of different people in the same way as subjective values help the individual to co-ordinate the parts of his plan” (Hayek 1945b, p. 85).

“We must look at the *price system* as such a *mechanism for communicating information* if we want to understand its real function – a function, which, of course, it fulfills less perfectly as prices grow more rigid” (Hayek 1945b, p. 86).

However, Hayek did not elaborate on the question as to under which conditions prices are flexible enough for the price system to fulfill this function. Moreover, if the major, or even the only, content of the information is the relative scarcity of resources, it is difficult to detect any difference to neoclassical price theory. What can be said at most is that the function which the price system is supposed to accomplish is the same in both Hayekian and neoclassical theories. But explanation of how it works is different, which might be interpreted as the core of the Socialist Calculation Debate (SCD). What Hayek contends is merely that price system can work and fulfill its function only under market competition whereas under simulated competition of market socialism it cannot. The other difference may be that for Hayek it must not necessarily be equilibrium prices in order that price system work; prices, if not administratively set, may work toward equilibrium: Hayek seems to suggest that in a competitive market even non-equilibrium prices can coordinate different plans of individuals by communicating relevant additional information to them.

“Of course, these adjustments are probably never “perfect” in the sense in which the economist conceives of them in his equilibrium analysis. ... The marvel is that in a case like that of a scarcity of one raw material, 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; that is, *they move in the right direction*. This is enough of a marvel even if, in a constantly changing world, not all will hit it off so

all the things made of tin, and their substitutes, and so on; and all this without the great majority of those instrumental in bringing about these substitutions knowing anything at all about the original cause of these changes. The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all.”

perfectly that their profit rates will always be maintained at the same or “normal” level” (Hayek 1945b, p. 87; italics added).³⁸

Thus Hayek came to the conclusion that the knowledge problem, to the existence of which he rightly pointed in criticizing tautological statements of “formal equilibrium analysis”, is now solved by his ‘knowledge argument’ that the price system in the competitive market functions as “a system of telecommunications”:

“The most significant fact about this system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action. In abbreviated form, by a kind of symbol, only the most essential information is passed on and passed on only to those concerned. It is more than a metaphor to describe the *price system as a kind of machinery for registering change, or a system of telecommunications* which enables 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” (Hayek 1945b, pp. 86-7; italics added).

Furthermore, Hayek sees in the price system not only mechanism of more efficient use of resources by solving the knowledge problem but also social device for individual liberty:

“The problem is precisely how to extend the span of our utilization of resources beyond the span of the control of any one mind; and, therefore, how to dispense with the need of conscious control and how to provide inducements which will make the individual do the desirable things without anyone having to tell them what to do” (Hayek 1945b, p. 88).

And this problem is not peculiar to economics but is connected with “nearly all truly social phenomena, with language and with most of our cultural heritage”:

“We make constant use of formulas, symbols, and rules whose meaning we do not understand and through the use of which we avail ourselves of the assistance of knowledge which individually we do not possess. We have developed these practices and institutions by building upon habits and institutions which have proved successful in their own sphere and which have in turn become the foundation of the civilization we have built up. The price system is just one of those formations which man has

³⁸ Desai (1994, p. 46) asks in this respect: “How do we know that it is a movement towards an equilibrium if we have no way of knowing that such an equilibrium exists?”

learned to use (though he is still very far from having learned to make the best use of it) after he had *stumbled upon it without understanding it*. Through it not only a division of labor but also a co-ordinated utilization of resources based on an equally divided knowledge has become possible” (Hayek 1945b, p. 88).

That is, Hayek seems to suggest that price mechanism must be understood in terms of spontaneous orders and rules, the observance of which gives orientation to individuals in a uncertain world. Hayek elaborates on this line in his later work on spontaneous order and cultural evolution. Seen in this perspective, the most important document of Hayek’s Transformation might be his 1945 paper (Hayek 1945b) rather than 1937 paper.

The problems relating to the ‘knowledge problem’ and the ‘knowledge argument’ or to the interpretation of the interrelation between them are observed by some authors in one way or another. Perhaps the most critical of all is Desai (1994) who argues that after Hayek referred to the problem regarding division of knowledge as the central problem of economics as a social science in his 1937 paper,

“Hayek discovered by 1945 that the problem was solved by the price system. So it was needless to have castigated economics as having neglected the problem. ... The price system and the elegance with which it solves the problem of fragmented knowledge becomes by repetition the whole content of Hayek’s economics in the years following 1945” (Desai 1994, p. 49).³⁹

A most controversial problem in this regard is how the price system works under disequilibrium states from which prices must start if we suppose the knowledge problem and if we are to analyze the process of subjective data approaching the objective facts.⁴⁰ Hayek argues:

³⁹ Desai (1994, p. 47) goes even so far as to say: “Hayek merely invokes the magic words ‘the price system’ without examining its entrails. It is as if correctly sensing the importance of sunlight for life on earth, we were to merely worship the sun rather than study astronomy or photosynthesis.” Vaughn (1999, p. 134) attempts to defend Hayek by arguing that “There is no doubt that “The Use of Knowledge in Society” [Hayek 1945b] is an article extolling the price system. However, given Hayek’s purpose which was to bolster his arguments against administered prices in central planning schemes, perhaps the strong emphasis he places on the communicating properties of prices may be treated as exaggeration to make a point.” In my view, however, Vaughn’s defense is not sufficient to refute the *substance* of Desai’s critique.

⁴⁰ Some questions which Arrow (1987, p. 203) raises might be interesting also in our context: “How can equilibrium be established? The attainment of equilibrium requires a disequilibrium process.

“The mere fact that there is *one price for any commodity* – or rather that local prices are connected in a manner determined by the cost of transport, etc. – brings about the solution which (it is just conceptually possible) might have been arrived at by one single mind possessing all the information which is in fact dispersed among the people in the process” (Hayek 1945, p. 86; italics added).

As Desai (1994, p. 46) remarks, “to say that one price exists is already to presume that an equilibrium exists, not to have shown that necessary and sufficient conditions are satisfied to bring it about.” While admitting that Hayek is primarily concerned with the communication-of-information function fulfilled by equilibrium prices, Kirzner (1984b, p. 146), however, tries to show that disequilibrium prices also have the property of coordinating (and thus ‘equilibrating’) but in a different sense from equilibrium ones:

“Equilibrium prices co-ordinate because they are already so adjusted (‘pre-reconciled’) that decisions that take these prices into account turn out to be mutually reinforcing. Disequilibrium prices can, if at all, to alert market participants, how altered decisions on their part (from those that contributed to the emergence of these disequilibrium prices) may be wiser for the future. ... to the extent that disequilibrium has manifested itself in the emergence of many prices in the same market for tea, this very spread between high and low prices suggest to some alert entrepreneurs that arbitrage profits may be won through offering to buy at somewhat higher (than the lowest) prices and simultaneously offering to sell elsewhere at somewhat lower (than the highest) prices.”

That is in case of disequilibrium states the prices play the role of alerting entrepreneurs to discover opportunities for exploiting (arbitrage) profit and in this to contribute to move the market to the equilibrium.⁴¹ But as Vaughn (1999, p. 134) remarks,

What does rational behavior mean in the presence of disequilibrium? Do individuals speculate on the equilibrating process? If they do, can the disequilibrium be regarded as, in some case, a higher-order equilibrium process?” See also Klausinger (1990, p. 67f.).

⁴¹ For a critique of Kirzner’s theory of market and entrepreneurship see Buchanan and Vanberg (1991, pp. 174ff.) who argue that “in spite of his emphasis on innovative entrepreneurial dynamics and in spite of his verbal recognition of the *creative* and *open-ended* nature of the market process, Kirzner’s approach fails to escape the subliminal teleology of the equilibrium framework” (ibid, p. 174.). Vaughn (1992, p. 271 and p. 253) also argues that in Kirznerian framework Austrian economics can merely serve as “useful addenda” to neoclassical economics as Kirzner’s theory of entrepreneurship amounts to “providing an explanation of how equilibrium in principle is capable of being achieved in real markets” by assuming the entrepreneur as a “prime mover in markets”.

“this does not entirely solve the problem of what information is conveyed by non-equilibrium prices.”⁴²

Meaning and role of Competition

As in the case of his knowledge argument Hayek’s notion of competition results from his critique of neoclassical notion of perfect competition. What is important for understanding the role of competition is not whether it is perfect or not, but whether it is allowed to work out at all. That is, the contrast must be drawn not between perfect and imperfect competition but between competition and non-competition. This line of reasoning is also influenced by his debates with socialists in SCD. This is thus also a case for my assertion that Hayekian theory can best be understood in light of his debates with ‘neoclassical socialists’. What Hayek intended to show ultimately regarding competition is that competition in real markets cannot be simulated or imitated by a fictive market equivalent in the model of market socialism.⁴³ It is based on his insight that efficiency properties of the real market cannot be brought about by fictive or ‘quasi-competition’ of market socialism and that competition in the real market works differently from the perfect competition which is unattainable in the real world. Hayek must have recognized that if results of market competition are to be compared to those of perfect competition with its Pareto-efficiency or optimality and market socialists suggest that the results of perfect competition can be obtained in their model, it would be difficult to explain the merits of real capitalism or market economy. Hayek also recognized that government intervention could be justified allegedly to bring the market nearer to the model of perfect competition (cf. Hayek 1954)

⁴² Furthermore, Boehm (1989, p. 207) notes that “Hayek does not come up with – and this is a very serious omission – an account of price formation; indeed, this crucial problem with which General Equilibrium theorists have grappled for so long is hardly addressed by him.”

⁴³ Hodgson (1998, p. 410) suggests that the term ‘market socialism’ is “highly misleading”: “Lange and others confusingly used the term ‘market socialism’ to refer to their models of an economy in which the workings of the market were simulated rather than a true market itself being accommodated. In fact, the models developed by Lange and his collaborators involved a high degree of centralized coordination and knowledge that excluded any real-world market”.

What concerned Hayek was the view generally held by neoclassical economists “that the co-called theory of “perfect competition” provides the appropriate model for judging the effectiveness of competition in real life and that, to the extent that real competition differs from that model, it is undesirable and even harmful” (Hayek 1946, p. 92). For Hayek there is no justification for this view, which results from erroneously applying or extending the Pure Logic of Choice (which is appropriate for the analysis of individual equilibrium) to a social process in which plans of individuals are adjusted to the objective facts of their environment including the action of the other people (Hayek 1946, p. 93; cf. Hayek 1937). This theory “assumes that state of affairs already to exist which ... the process of competition tends to bring about” and therefore

“if the state of affairs assumed by the theory of perfect competition ever existed, it would not only deprive of their scope all the activities which the verb “to compete” describes but would make them virtually impossible” (Hayek 1946, p. 92).

Perfect competition not only misconceives the process of real competition but it is also counter-factual for Hayek. It is counterfactual because conditions of perfect competition (homogenous commodity, buyers and sellers as price-takers, complete knowledge of market participants) are not given in the real world.⁴⁴ The knowledge which market participants are assumed to possess are the facts which can only be discovered by the process of competition: the lowest production cost and “the wished and desires of the consumers including the kinds of goods and services which they demand and the prices they are willing to pay” (Hayek 1946, pp. 95-6). Therefore, “the starting point of the theory of competitive equilibrium assumes away the main task which only the process of competition can solve” (ibid, p. 96).

In his famous article *Competition as a Discovery Procedure* (Hayek 1968), Hayek made similar critique of perfect competition:

⁴⁴ Cf. Hayek (1946, p. 96): “The peculiar nature of the assumptions from which the theory of competitive equilibrium starts stands out very clearly if we ask which of the activities that are commonly designated by the verb “to compete” would still be possible if those conditions were all satisfied. ... Advertising, undercutting, and improving (“differentiating”) the goods or services are all excluded by definition – “perfect” competition means indeed the absence of all competitive activities.”

“[T]he absurdity of the usual procedure of starting the analysis with a situation in which all the facts are supposed to be known. This is a *state* of affairs which economic theory curiously calls ‘perfect competition’. It leaves no room whatever for the *activity* called competition, which is presumed to have already done its task” (Hayek 1968, p. 182).

For Hayek competition is comparable to “a voyage of exploration into the unknown, an attempt to discover new ways of doing things better than they have been done before” (Hayek 1946, p. 101). Later, he suggested to consider competition “as a discovery of such facts, without resort to it, would not be known to anyone, or at least would not be utilized (Hayek 1968, p. 179).⁴⁵

Through his works on competition Hayek provided some arguments which could complement and extend his knowledge argument: markets do not only coordinate *given* knowledge but contribute to discover *new* knowledge. Moreover, he added political argument of liberty to his theory of competition: not only is in the market order dispersed knowledge best utilized but it requires no consensus on the relative importance of ends and it can do without arbitrary coercion of the state (because for Hayek it refers rather to “impersonal compulsion”).⁴⁶

Eatwell and Milgate (1994) argue, however, that efficiency properties of competition and market order which Hayek claims for *his* concept of competition does not obtain without recourse to neoclassical theory of price determination and of perfect competition and equilibrium.⁴⁷

⁴⁵ Hayek emphasized again what kind of knowledge he had in mind in this regard: “The knowledge of which I speak consists rather of a capacity to find out particular circumstances, which becomes effective only if possessors of this knowledge are informed by the market which kinds of things or services are wanted, and how urgently they are wanted” (Hayek 1968, p. 182). Probably in allusion to Socialist Calculation Debate he argued once more that individuals cannot list and communicate this kind of knowledge to a central authority even if they are asked to (ibid.).

⁴⁶ Cf. Hayek (1968, p. 189: italics added): “Required changes in habits and customs will be brought about only if the few willing and able to experiment with new methods can make it necessary for the many to follow them, and at the same time to show them the way. ... Competition produces in this way a kind of *impersonal compulsion* which makes it necessary for numerous individuals to adjust their way of life in a manner that *no deliberate instructions or commands could bring about*.”

⁴⁷ Eatwell and Milgate (1994, p. 91f.) suggest in his regard: “The contradictions in Hayek’s arguments on competition and market order could be resolved in two ways: by abandoning his characterization of competition altogether and accepting perfect competition as an integral part of the theory of price determination; or by preserving the insights he has into the nature of capitalistic competition and seeing some replacement for the neoclassical theory of price determination.”

Socialist Calculation Debate (SCD)

Participation in the SCD was arguably the most important academic event for Hayek. It is observed and remarked by increasing number of scholarship on Hayek and Austrian economics that participation in the SCD was pivotal for Hayek to turn his attention to deal with wider problems of society and polity beyond economy, to develop ‘economics and philosophy of liberty’. It led Hayek to recognize or rather rediscover distinctiveness of his Austrian position compared to that of neoclassical economics on which socialists fell back.⁴⁸ With the benefit of hindsight we can say SCD contributed to the process of finding self-identity of Austrian economics in general and Hayek in particular.⁴⁹ How important this event is for Hayek and Austrian economics is once more evidenced by the fact that ‘revival’ of Austrian economics from the late 1970s concurs with and advanced, if not first initiated, by reexamination of SCD by Austrian economists.⁵⁰

This should not confuse the fact that Hayek himself was in his early career engaged with conventional economics not that different from neoclassical economics, especially in terms of equilibrium concept.⁵¹ Hayek believed at the outset of the debate he was a member of established economics profession that time.⁵² Only through

⁴⁸ For Hayek’s direct contribution to the debate, see Hayek (1935a; 1935b; 1940). Hayek’s comments on and allusion to the debate, however, are to be found at various places in his works including his latest work (Hayek 1988, p. 87).

⁴⁹ Kirzner (1988, p. 102) put it: “What occurred as a result of the vigorous inter-war debate was that the Austrians were inspired, not to retreat, but to identify more carefully the aspects of their understanding of market processes that their critics had failed to recognize. This process of increasingly precise articulation was not merely one of improved communications; it was a process of improved self-understanding”.

⁵⁰ Cf. Vaughn (1990, p. 388): “Modern Austrian economics owes its demise and rebirth to a putative failure: the debate over the economics of socialism.” For more on a ‘revisionist’ view which (re)interprets the debate from a perspective favorable to Austrian school in general and Hayek in particular see Vaughn 1980, Lavoie 1985, Caldwell 1988, Kirzner 1988, Keizer 1989.

⁵¹ Cf. Vaughn (1990, p. 389; emphasis added): “Because of the static equilibrium framework within which Hayek developed his theory in [Prices and Production (Hayek 1931)], it reads more like a *neo-classical rendering of some Austrian insights* than a work in Austrian economics.”

⁵² Cf. Vaughn (1990, p. 389): “Interestingly, when he technically started the debate in 1920 Mises believed that the arguments he produced to support his famous contention that economic calculation under a socialist regime was impossible, were not particularly Austrian but were simply good economic arguments. Perhaps even more than Mises, Hayek viewed himself as a part of a broad scholarly community that had progressed beyond distinctions as to school and country of origin.”

exchange with neoclassical socialists did he clearly realize that he cannot formulate forceful attacks on them in their terms⁵³.

This means that he cannot base his normative justification of market economy or capitalism on perfectly competitive model which was used by market socialists like Lange, Taylor, and Dickinson. This was a rare opportunity or challenge to Hayek to develop his brand of arguments to criticize neoclassical theory and socialism simultaneously. As Vaughn (1990, p. 389) observed:

“Perhaps it was easy for Hayek in the early “years of high theory” to believe he was part of one scholarly community when the questions under discussion were limited to how one defined capital or what the role of bank money was in a trade cycle. Differences of opinion are the stock in trade of science, and one expects to encounter opposition to new ideas and to argue hard for one’s new theory. Besides, when arguing for specific pieces of theory, one generally assumes the basic framework. However, the debate over socialism was different. When arguing over the feasibility of replacing a market economy with a centrally planned economy, *the totality of an economist’s understanding of markets* is called into play. It is not a surprise, then, that the very basic differences of world view between Hayek and the market socialists would hamper communication” (emphasis added).

It is now widely recognized that further insights and arguments which Hayek developed during and a few years after his participation in SCD is a prime cause of Hayek’s transformation.⁵⁴ This included not simply his qualification (or modification), though not outright jettison, of (neoclassical) equilibrium construct⁵⁵, but his turning to wider themes and disciplines than narrow ‘technical economics’. This does mean, however, that Hayek had given up economics altogether: Hayek might have realized that technical economics is not enough to constitute ‘economics and philosophy of liberty’ which is more appropriate for understanding and justifying liberal society based on market economy.

⁵³ Cf. Bowels and Gintis (2000, p. 1429): “Hayek himself apparently concluded that it had been a mistake to conduct the debate in Walrasian terms, and in the late 1930s and early 1940s developed the analytical foundations of a more plausible Austrian alternative to the Walrasian model. ... Hayek’s appreciation of the importance of information allowed him to pinpoint a decisive weakness of central planning unavailable to the Walrasian economist, namely the planner’s inability to acquire the information necessary to determine socially efficient prices.”

⁵⁴ Though Vaughn (1990, p. 388, no. 19) sees this rather a “rediscovery” of what Hayek learned from Menger through Mises than a transformation, the point she is making is essentially the same with Caldwell (1988).

⁵⁵ Cf. Klausinger (1990).

It might not be an exaggeration to say that Hayek's work, at least after the middle of the 1930s, can be best understood in light of his arguments concerning market socialism.

What are then fundamental insights that Hayek gained in connection with the SCD which are to shape the direction in which his further research on the 'economics and philosophy of liberty' goes? The basic claim of the market socialists that socialism, without markets for productive resources, can work efficiently (even more efficient than capitalism) was based on the view that markets in capitalism are supposed to work in accordance with perfectly competitive model. Given monopoly and external effects etc. in real capitalism, they contend, planners (Economic Planning Board, for instance) playing the role of Auctioneer can better approximate the perfectly competitive model than the real capitalism (cf. Lange 1938). Hayek must have recognized one policy-bias of general equilibrium economics which goes beyond policy-neutrality of Walrasian economics.⁵⁶ What market socialists theoretically contend is the system-neutrality of the price system. It is the theoretical core of economists of socialism from Enrico Barone (1908) who first formalized the mathematical equations which must and can, in principle, be solved by any economic system.⁵⁷ This explains the rather polemical but substantial remark of Oskar Lange that Mises' (1920) claim of impossibility of economic calculation⁵⁸ in socialism is institutionalist⁵⁹, which, unlike the latter's usual position, calls universal applicability of economic theory into question:

⁵⁶ Cf. Bowles and Gintis (2000, p. 1425): "Contrary to the claims of many of its critics, Walrasian economics never had a policy agenda. From Walras to the present, the policy positions of its leading exponents ranged from a confidence in the ability of government to implement a social optimum, without markets, by a state functionary acting as the Walrasian "auctioneer" on the one hand, to an equally unbounded faith in the ability of markets to achieve a social equilibrium without state intervention on the other."

⁵⁷ On this Hayek remarked later (1945b, p. 90, fn. 1): "Professor Schumpeter is, I believe, ... the original author of the myth that Pareto and Barone have "solved" the problem of socialist calculation. What they, and many others, did was merely to state the conditions which a rational allocation of resources would have to satisfy and to point out that these were essentially the same as the conditions of equilibrium of a competitive market. This is something altogether different from showing how the allocation of resources satisfying these conditions can be found in the practice. Pareto himself (from whom Barone has taken practically everything he has to say), far from claiming to have solved the practical problem, in fact explicitly denies that it can be solved without the help of the market."

⁵⁸ Cf. Murrell (1983).

⁵⁹ This is polemical because Lange added that: "I am, of course, perfectly aware that Professor Mises does not regard himself as an institutionalist and that he has stated explicitly the universal validity of economic theory" (Lange 1938, p. 62, fn. 6).

“Professor Mises argues that private ownership of the means of allocation is indispensable for a rational allocation of resources. Since, according to him, without private ownership of the means of production no determinate index of alternatives exists (at least in the sphere of capital goods), the economic principles of choice between different alternatives are applicable only to a special institutional set-up, i.e., to a society which recognizes private ownership of the means of production. It has been maintained, indeed, by Marx and by the historical school (in so far as the latter recognized any economic laws at all) that all economic laws have only historico-relative validity. But it is most surprising to find this institutionalist view supported by a prominent member of the Austrian school, which did so much to emphasize the universal validity of the fundamental principles of economic theory.⁶⁰ Thus Professor Mises’ denial of the possibility of economic calculation must be rejected” (Lange 1938, pp. 61-2).

In emphasizing universal validity of economic theory regardless of different systemic configurations Lange once more stressed that Mises claim is institutionalist:

“For if [Mises’] assertion is true, economics as the theory of allocation of resources is applicable only to a society with private ownership of the means of production. *The implications of the denial of the possibility of rational choice in a socialist economy are plainly institutionalist*” (Lange 1938, p. 62; emphasis added).

Though this remark was not directly answered by Hayek and also passed unnoticed by subsequent Austrian literature on the debate, it is now vindicated by increasing literature which emphasized ‘institutionalist’ features of Hayekian economics which were further developed and at least implied, if not explicitly stated in terms of economics, in his later rather philosophical and methodological work.⁶¹ Of course

⁶⁰ This reveals unwittingly how Austrian school was perceived by economic profession, perhaps including Austrians themselves like Mises and Hayek, at the time of the debate during the 1930s and 1940s. For Lange Austrian school represented above all by Wieser and Böhm-Bawerk was just one branch of marginal utility school which led him to assert: “Economic theory as developed by the Austrian, Marshallian and Lausanne schools is essentially a *static* theory of economic equilibrium analyzing the economic process under a system of constant *data* and the mechanism by which prices and quantities produced adjust themselves to changes in these data” (Lange 1935, p. 192; emphasis in the original).

⁶¹ Whether Hayek did not use any equilibrium construct whatsoever in his later work is a highly controversial issue which has not yet been settled. For more on this and related issue of ‘institutionalist’ or ‘realist’ features in Hayek’s theory see Ebeling 1986; Klausinger 1990; Fleetwood 1996; Vaughn 1999.

While Vaughn admits that “unfortunately, Hayek did not himself try to rewrite economic analysis in light of his [later] work on social institutions” (1999, p. 138), she argues in this regard: “It is well known that in “Economics and Knowledge,” Hayek explored the assumptions about time and knowledge that must underlie a coherent use of equilibrium, and thereby, perhaps inadvertently, called the whole equilibrium notion into question. After that promising beginning, Hayek did not directly ad-

Lange's point was that Mises general position is tantamount to that of historicism that argues relativity of theory under different historical phases and institutional features.

The most proper answer by Hayek to market socialism would be that the real capitalism works differently from the perfectly competitive model; that simulation of market and price system is impossible; that they work only under distinctive institutional features which cannot be obtained in planned economy, however variously decentralized the decision-making might be. This Hayek has done in his life-time.

Put it somewhat boldly, the claim of market socialists is based on their thesis of universal applicability of (neoclassical !) economic theory whereas Hayek's claim amounts to arguing institutional relativity of economic system on the basis of universal applicability of (Austrian !) economic theory. This apparent paradox that for one side universal applicability of economic theory means feasibility of socialism and for the other side its impossibility can be solved for the Austrians in that institutional features which are necessary for the beneficial working of market economy can be captured only by Austrian theory. Therefore in their view Austrian theory can explain both the working of market economy and shortcomings of market socialism whereas the neoclassical economic can explain neither.

The task Hayek set himself is to constitute a theory which captures institutional features of real capitalism without which the functioning and efficiency or benefit of market and price system cannot be explained. Stated otherwise, Hayek recognized that he cannot explain or justify superiority of market economy and price system on the basis of neoclassical theory with its focus on equilibrium states rather than process and with its assumption of perfect knowledge and perfect competition, which are

dress the question of equilibrium again, yet the issues that concerned him in that essay shaped most of his later writings about markets and social processes in general. It is not surprising, then, that Hayek's later writings would contain the major ingredients for an account of market order that does not rely on conventional notions of equilibrium. It is also not surprising that such an important contribution to economic theory has not been more widely recognized since Hayek never specifically labeled his alternative formulation as "economics" per se. Yet, his many subsequent writings on social and political theory depend upon an *implicit economics* that for the most part is only alluded to in the context of other topics (ibid, p. 130; emphasis added).

not given in the world out there.⁶² How can the efficiency of market economy be justified on the ground of general equilibrium and Pareto-efficiency which are, if at all, rarely given in the real capitalism?⁶³ Hayek saw the danger of associating market economy with perfect competition, for example, for it only justifies government intervention (cf. Hayek 1954). In a sense SCD is more significant for Hayek as a momentum for delivering new insights to the understanding of market economy than for launching the criticism of socialist economy as such, though two issues are closely related for Hayek.

What market socialists who have allegedly won the SCD⁶⁴ demonstrated is not economic feasibility of socialism but rather theoretical or logical coherence of neoclassical theory within its own model.

⁶² Vaughn's comment on the SCD is thus convincing: "the controversy between the advocates of socialism and their critics was at heart a contest of *theoretical models based on differing perceptions of what a market economy really was*" (Vaughn 1980, p. 552; emphasis added).

⁶³ At various places Hayek's concern is expressed: to show on the one hand that conditions for competitive equilibrium are not given in the real word, that therefore it is a mistake to compare the performance of real world market with competitive equilibrium where optimal (the absolute best) results obtain; and to demonstrate on the other hand that the (relative) best results which can be achieved under real conditions are those produced by the real market mechanism (operating under the condition of dispersed and tacit knowledge and under 'free' and not perfect competition and to suggest that it is not a shortcoming that the results of real market may be suboptimal by the ideal standard which is unreal. Thus assessment and understanding of comparative economic system cannot be made on the basis of neoclassical equilibrium theory: "In order that the results of the combination of individual bits of knowledge should be comparable to the results of direction by an omniscient dictator [which Hayek seemed to believe are equivalent to equilibrium with optimum] further conditions must apparently be introduced" (Hayek 1937, p. 53); "I fear that our theoretical habits of approaching the problem with the assumption of more or less perfect knowledge on the part of almost everyone had made us somewhat blind to the true function of the price mechanism and led us to apply rather misleading standards in judging its efficiency" (Hayek 1945b, p. 87); "The basis of comparison, on the grounds of which the achievement of competition ought to be judged, cannot be a situation which is different from the objective facts and which cannot be brought about by any known means. It ought to be the situation as it would exist if competition were prevented from operating. Not the approach to an unachievable and meaningless ideal [of perfect competition] but the improvement upon the conditions that would exist without competition should be the test" (Hayek 1946, p. 100); "We should worry much less about whether competition in a given case is perfect and worry much more whether there is competition at all. What our theoretical models of separate industries conceal is that in practice a much bigger gulf divides competition from no competition than perfect from imperfect competition" (ibid, p. 105); "Yet we do injustice to the achievement of the market if we judge it, as it were, from above, by comparing it with an ideal standard which we have no known way of achieving. If we judge it, as we ought to, from below, that is, if the comparison in this case is made against what we could achieve by any other method – especially against what would be produced if competition were prevented, so that only those to whom some authority had conferred the right to produce or sell particular things were allowed to do so" (Hayek 1968, p. 185).

⁶⁴ Cf. Schumpeter (1942/1950, pp. 172ff) and Bergson (1967).

What Lange and others⁶⁵ demonstrated was that at the level of pure analysis neoclassical equilibrium theory can be used to justify the collective ownership of property and centralized planning by the state. This can be explained by lacking institutional features in the neoclassical theory: “The basic problem with the Walrasian model in this respect is that it is essentially about allocations and only tangentially about markets” (Bowles and Gintis 2000, p. 1428):

“Lange pointed out that markets and private property play a purely metaphorical role in general equilibrium theory. There is no competition in the sense of strategic interaction The only factors determining individual and firm behavior are prices. Nor do markets have any function in the Walrasian model. In Walras’ original description, market clearing was not affected by markets at all, but rather by an “auctioneer” who assumed that all economic agents revealed truthfully their personal knowledge and preferences. Thus, prices need not be set by market interactions or any other particular mechanism. From the standpoint of the Walrasian model, a central planner could play the part of Walras’ auctioneer, setting prices to clear markets in a manner that is perfectly compatible with economic efficiency” (Bowles and Gintis 2000, p. 1428).

That deep and many-sided insights concerning the working of market economy on the one hand and concerning the achievements and still remaining limits of analysis based on neoclassical approach in a broad term on the other can still be reaped from the SCD, which, as Hodgson (1998, p. 409) put it, is “one of the most illuminating and significant debates in economic theory in the twentieth century”, is demonstrated by the renewed controversy over market socialism. This ‘new generation’ of market socialism models attempts to improve Lange-Lerner model of market socialism through incorporating its critique by ‘new information economics’ represented in this regard by Joseph Stiglitz. The new generation of market socialists, represented above all by Bardhan and Roemer (1992) on the one and Stiglitz (1994) on the other criticized early model of market socialism for its failure to address problems of incentive and monitoring which are associated with public ownership. This is not the place to deal with new proposals of market socialism in detail.⁶⁶ What must be recorded for my purpose is that both new models of market socialism and new infor-

⁶⁵ Cf. Dickinson (1933); Lerner (1936); Taylor (1929); Lange (1938).

⁶⁶ For a comprehensive survey of new models of market socialism and their relation to Austrian and new information economics critique of new and old market socialism see Milonakis (2003).

mation economics do not deal with real market socialism but attempt to build models as did the early market socialists. As Milonakis (2003, p. 115 and p. 116) puts it:

“From Lange’s model, to Stiglitz’s critique to Bardhan and Roemer’s proposals, the chief concern has been the construction of models, which are treated as ideal, ahistorical constructs with universal validity. In this way, all historical and social context is lost, and the theoretical reproduction of reality is simply treated as an exercise in model building. ... the fact of the matter remains that their [Bardhan and Roemer’s] proposals represent no more than a simple extension of Lange’s to take into account incentive problems. They do this simply by changing some of the assumptions of the model. Everything else – methodologically and substantively – remains the same”.

Milonakis (*ibid*, p. 116) is, however, by his misunderstanding of the nature of Hayekian theory, led to lump together new and old market socialists on the one hand and Hayek on the other in criticizing “methodological individualism and subjectivism inherent in both neoclassical and Austrian economics”. He argues further that methodological individualism is “necessarily associated with reductionism since it attempts to explain the whole through its analytical reduction to its presumed micro-foundations and component parts”. It is “complemented by the total divorce of the economic from the social: both are understood in terms of the actions of individuals. In other words, structures are explained in terms of individual motivation”.

For one thing, it is controversial to what extent Hayek adopted or championed methodological individualism. In my view, it is now evident that at the very minimum Hayek’s methodological stance is different from the strong version of methodological individualism of neoclassical economics (see below Ch. 4). A most fundamental problem in this regard is that not only mainstream economists but heterodox economists, above all, theorists of OIE (Old Institutional Economics) did not understand Hayekian message regarding SCD nor substantive nature of Hayekian challenge for OIE. More specifically this homogenization of neoclassical economics and Austrian economics, which to rebut is an important source and effect of ‘revisionist’ interpretation of SCD and of Austrian revival, cannot cope with recent reinterpretations of Hayek.⁶⁷ In spite of their different settings, their commonality seems to be the view that Hayek’s knowledge argument and his appreciation of price system in market

⁶⁷ Cf. Ebeling 1986; Fleetwood 1996; Vaughn 1999.

economy as telecommunication system of knowledge can best understood when ‘institutional features’ in Hayekian economics are fully taken into account.⁶⁸ Thus if scholars of OIE stick to the critique of Hayek as methodological individualist with its reductionist, ahistorical and asocial nature who ignores institutional dimensions of economy, they are, ironically, attacking ‘a straw man’ and are missing the point. Though it might sound somewhat paradoxical, Hayekian theory is more challenging to OIE than mainstream economics is to OIE.

The problem which must be dealt with is to examine the nature of institutional dimensions which do reside with Hayekian ‘economics and philosophy of liberty’. This would reveal that Hayekian theory is a more dangerous form of economic imperialism⁶⁹ with its message of disembedding in the end (see below Ch. 2 and Ch. 6). Thus formulated, the real challenge of Hayekian ‘economics and philosophy of liberty’ is that it constitutes economism without recourse to economic imperialism. So if we criticize neoclassical economics and Hayekian theory at the same level and with the same logic, it would not only lead to overlook the real nature of Hayekian challenge but also to lose Hayekian insights out of sight which could serve attacking neoclassical economics.

Formulated bluntly, the challenge is to find out the way how Hayek could disguise his disembedding content with his embeddedness outlook. Both sympathizers and critics of Hayekian position could not escape the confusion. Thus Caldwell (1997, pp. 1870-1; italics added), a Hayekian economist, could write: by criticizing laissez-faire Hayek meant that:

“Market system must be embedded in a set of other institutions – a democratic polity, with strong constitutional protection of a private sphere of individual activity, with enforced and exchangeable property rights – if it is to work. The problems of the Eastern European transition have made these ideas seem almost obvious”.

⁶⁸ They may add some additional insights of ‘institutional’ dimensions to Hayekian theory but they can neither recognize nor criticize ‘social blindness’ of Hayekian theory.

⁶⁹ I am tempted to differentiate economic imperialism from economics imperialism (cf. Fine 2002), but since economic imperialism is occupied otherwise already in the sense of imperialism of neoclassical economics, it seems more appropriate to differentiate economic imperialism from economism (*Ökonomismus* in German) or economic determinism.

It is not certain whether Caldwell means Hayek's ideas lend support to gradualist approach to systemic transition which institutionalists and Post-Keynesians strongly advocated or to the opposite approach of shock therapy or big-bang by mainstream economists. On the one hand, it might be argued on the basis of Hayek's alleged embeddedness that systemic transition must be shaped carefully and gradually taking into account traditional, historical, social and cultural givens of the affected countries, which rivals one-size-fits-all policy suggested by mainstream economists.⁷⁰ On the other hand, it might be argued also on the basis of Hayek that since institutions supporting market system are absent in the former Eastern block, these institutions must be introduced as soon and consequent as possible if transition is to be understood as that from centrally planned economy to market economy and if the market economy is to work.⁷¹ It shows that Austrian economics cannot give a clear answer to the issue.⁷² My point is rather that it is important to understand what is meant by interpretation of Hayek incorporating 'embeddedness' and institutional features and dimension.⁷³

⁷⁰ For an early (critical) evaluation of theory and policy suggested and implemented by mainstream economists concerning transition see for example Murrell (1995).

⁷¹ I surmise that Austrian economists would disagree over the issue among themselves.

⁷² I am not certain to what extent this ambiguity can be described as an dilemma of Hayekian economics: As I shall deal with in more detail below, socialism, belonging to the category of organization in contrast to spontaneous order according to Hayekian taxonomy, can in principle reorganized to accommodate market mechanism (which represents the core of systemic transition). For Hayek most beneficial properties of market economy, however, are due to the latter being of spontaneous origin. Socialism is doomed to fail because it means converting a spontaneous order into an overall organization. So market arises and is not created. Thus Hayekian theory cannot explain problems of systemic transition or those of underdevelopment. This reduces the scope of his theory to countries where institutions have spontaneously arisen already which underpin the proper functioning of market economy. It might lead to a tautology that market thrives where conditions are ripe in that market-supporting institutions are already there.

⁷³ It might be remarked in this context that to emphasize 'institutional dimensions' in Hayekian economics, though it might sound paradoxical, is the best way to demonstrate and preserve distinctiveness of Hayekian theory against recent developments in economic theory. For example see Stiglitz's assessment of Hayek's contribution to information economics: "Hayek was correct in arguing that the central problem of economics was a problem of knowledge or information ... But he, like so many of the nineteenth and early twentieth century economists, focused too narrowly on the admittedly central problem of information about scarcity" (Stiglitz 2000, p. 1469). Beside the fact that different conceptions of knowledge are underlying Stiglitz' (asymmetric information) and Hayekian scheme (dispersed and tacit knowledge), Hayek is interpreted as merely pointing to informational function of price system embodied in the neoclassical equilibrium theory. Austrians must show that Hayekian scheme offers more than this. It can be best done by emphasizing 'institutional dimensions' of Hayekian theory.

2. Embeddedness of Karl Polanyi

With his notion of embeddedness Polanyi meant that market economy must be embedded in society if it is to survive. It is both critical of economic imperialism and economism which he detected in both liberal classical and Marxian political economy. His notion of embeddedness which is directly related to his critique of the assumption of self-regulating market can be seen to show that a formal-logical interdependence of economic, social and political orders, which Hayekian theory certainly displays, is not enough to claim the notion of embeddedness. In spite of seeming similarity between (Hayekian) interdependence of orders on the one hand and Polanyian embeddedness on the other, Hayek, on the basis of the former, tried to underpin his policy stance of non-interventionism and to demonstrate that ‘social question (in the form of social justice)’ does not exist in advanced complex society and that any attempt to solve it would lead to demise of free society and market economy; whereas Polanyi, on the basis of the latter, tried to show that excessive focus on economic factors and (relative) overgrowth of economy beyond a certain scope would lead to catastrophic results and demise of society. It could be argued that both are right: Hayek deals with the question of society supporting economy whereas Polanyi with the question of social repercussion or even resistance to economy. However, Hayek’s theory cannot cope with the Polanyian critique of self-regulating mechanism. More importantly, their conception of economy is diametrically different. Hayek’s primary concern was how to ensure spontaneous orderliness of market or encapsulate it from the intrusion of social and political factors. Hayek’s dichotomy between spontaneous orders and organizations (see below Ch. 3) is in this context instrumental to express this concern. For Hayek market order is inherently stable with market mechanism of price system and competition transmitting and discovering knowledge necessary for market participants to make right decisions, bolstered by market-sustaining institutions which are themselves spontaneous orders (or at least ought to be made to behave *as if* they were). Market order can most likely be disturbed by government interferences which only serve to impose organizational character on spontaneous order if the Rule of Law does not prevail which *ought to be* accepted as a *meta principle* (cf. Hayek 1960, pp. 205ff.) and the coercive powers of

government are not correspondingly limited to a narrow scope and nature.⁷⁴ Liberalism in Hayekian context is no less than the attempt to minimize destabilizing forces resulting from government intervention. There is no positive role to play for organizations which are treated, conceptually, merely as residuals.⁷⁵ When he analyzes interdependence it is a rather one-sided approach. On the one hand Hayek knows no negative impacts of market order and its expansion on institutions and, on the other hand, for him institutions only sustain the market but in no way contain or counter-balance it. It is even not clear what would remain of society beyond market order (or economic sphere).⁷⁶

Thus, Hayekian ‘economics and philosophy of liberty’ may be interpreted, in spite of institutional dimensions and interdependencies, as an attempt to construct the idea of self-regulating market, albeit different from neoclassical one. Further, it is not *whether* but *how* institutional arguments are incorporated that is decisive.

Polanyi begins his *The Great Transformation* with a bold thesis that

⁷⁴ Cf. Gordon (1981, p. 476): “In Hayek’s ‘political economy’ the central problem is how to make government the servant of the system of spontaneous order and the solution of the problem of the relation of government to markets is made to rest upon the existence of ‘meta-legal’ principles which act as absolute moral constraints upon government.” Hayek claimed that he did not advocate a ‘minimal state’ but a limited government. To forestall some doubts in this regard Hayek distinguished coercive and non-coercive or service functions of the government and admitted a large scope of measures to the latter (Hayek 1960, CL, pp. 220-233, pp. 253-394; Hayek 1979, LLL 3, pp. 41-64). As Gordon (1981, p. 474) rightly points out, however, “despite the large agenda of legitimate and desirable functions of the State, their conformity with the requirements of spontaneous order is the sole criterion by which they should be assessed.” For similar line of critique on Hayek’s view of government see Guest (1997) and Viner (1961).

⁷⁵ In dealing with orders, Boehm (1994, pp. 298-9; emphasis added) argues, Hayek’s emphasis is “on the contrast between spontaneous orders and organizations. More correctly, the emphasis is on the distinctiveness of spontaneous orders relative to organizations. The latter is a rather *shadowy concept* in Hayek; it is *merely reactive to, or parasitic upon, the former*.” For more on this see Ch. 3

⁷⁶ Furthermore, in Hayekian scheme the political regime, democracy, affects market order only in a negative way if the former is not strictly constrained. How, on the other hand, market order affects democracy is not analyzed. This is even retreat from analysis of Scottish moral philosophers in this regard (cf. Hirschman 1977/1997; Winch 1977) whose heir Hayek claims himself to be. Hirschman (1986) analyzes diverse cases of interaction and relationship between development of capitalism on the one hand and non-economic (and pre-capitalistic) factors (values, institutions and traditions) on the other represented in various theories. Though I cannot elaborate further on it here, it would be a interesting task to interpret and assess Hayek’s theory, particularly his theory of spontaneous order and cultural evolution, on the basis of Hirschman’s *Tableau Idéologique* (Hirschman 1986, p. 136). A major point of critique of Gray (1998, pp. 146ff.) on Hayek is the latter’s neglect of social repercussions of market order.

“the idea of a self-adjusting market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness. Inevitably, society took measures to protect itself, but whatever measures it took impaired the self-regulation of the market, disorganized industrial life, and thus endangered society in yet another way. It was this dilemma which forced the development of the market system into a definite groove and finally disrupted the social organization based upon it” (Polanyi 1944/1964, pp. 3-4).

Talking about Industrial Revolution, he argued:

“What appeared primarily as an economic problem was essentially a social one. In economic terms the worker was certainly exploited: he did not get in exchange that which was his due. But important though this was, it was far from all. In spite of exploitation, he might have been financially better off than before. But a principle quite unfavorable to individual and general happiness was working havoc with his social environment, his neighborhood, his standing in the community, his craft; in a word, with those relationships to nature and man in which his economic existence was formerly embedded. The Industrial Revolution was causing a social dislocation of stupendous proportions, and the problem of poverty was merely the economic aspect of this event” (Polanyi 1944/1964, p. 129).

This line of reasoning underlies his critique of “economistic prejudice” (ibid, p. 159) or “materialistic fallacy” (ibid, p. 161). If one focus on economic exploitation he loses sight of a more fundamental problem – social dislocation. Not economic exploitation but social dislocation or “disintegration of the cultural environment of the victim” is the main cause and nature of degeneration. As Polanyi put it:

“The economic process may, naturally, supply the vehicle of the destruction, and almost invariably economic inferiority will make the weaker yield, but the immediate cause of his undoing is not for that reason economic; it lies in the lethal injury to the institutions in which his social existence is embodied” (Polanyi 1944/1964, p. 157).

Thus, the fatal effects of rapid industrialization for social degeneration, being the most fundamental problem,⁷⁷ remain valid even if one argues that:

⁷⁷ Polanyi argued that social and cultural degeneration can be also applied to and demonstrated by the situation faced by the natives in the contemporary colonies. “If exploitation is defined in strict economic terms as a permanent inadequacy of rations of exchange, it is doubtful whether, as a matter of fact, there was exploitation. The catastrophe of the native community is a direct result of the rapid and violent disruption of the basic institutions of the victim These institutions are disrupted by the very fact that a market economy is foisted upon an entirely differently organized community; labor

“by the accepted yardsticks of economic welfare – real wages and population figures – the Inferno of early capitalism ... never existed; the working classes, far from being exploited, were economically the gainers and to argue the need for social protection against a system that benefited all was obviously impossible” (ibid, p. 156).⁷⁸

Polanyi demonstrated, at least, that there is trade-off between economic growth and social stability. Rapid economic change entails social dislocation which is more painful for the whole society than can be judged by conventional economic criterion. He did not argue against economic progress per se, but for slowing the relative rate of economic change in order for the society to have time to adjustment. For Polanyi, interventionism would achieve this, and is the main task of the state.

Self-regulating market, commodity fiction, liberalism, embeddedness

Polanyi seemed to suggest that market economy, as a modern economic system, distinguishes itself from all previous economic systems by its ‘disembeddedness’⁷⁹.

“[N]ever before our own time were markets more than a accessories of economic life. As a rule, the economic system was absorbed in the social system, and whatever principle of behavior predominated

and land are made into commodities, which, again, is only a short formula for the liquidation of every and any cultural institution in an organic society” (Polanyi 1944/1964, p. 159). “It is the absence of the threat of individual starvation which makes primitive society, in a sense, more human than market economy, and at the same time less economic. Ironically, the white man’s initial contribution of the black man’s world mainly consisted in introducing him to the uses of the scourge of hunger. Thus the colonists may decide to cut the breadfruit trees down in order to create an artificial food scarcity or may impose a hut tax on the native to force him to barter away his labor. In either case the effect is similar to that of Tudor enclosures with their wake of vagrant hordes” (Polanyi 1944/1964, p. 164).

⁷⁸ Polanyi’s critique of “economistic prejudice” can be best understood in light of the question raised by some economic historians: “how could there be a social catastrophe where there was undoubted economic improvement?” (Polanyi 1944/1964, p. 157).

⁷⁹ “True, no society can exist without a system of some kind which ensures order in the production and distribution of goods. But that does not imply the existence of separate economic institutions; normally, the economic order is merely a function of the social, in which it is *contained*. Neither under tribal, nor feudal, nor mercantile conditions was there ... a separate economic system in society. Nineteenth century society, in which economic activity was isolated and imputed to a distinctive economic motive, was, indeed, a singular departure” (Polanyi 1944/1964, p. 71). “Under the gild system, as under every other economic system in previous history, the motives and circumstances of productive activities were *embedded* in the general organization of society” (ibid, p. 70). “That mercantilism, however emphatically it insisted on commercialization as a national policy, thought of markets in a way exactly contrary to market economy, is best known by its vast extension of state intervention in industry. ... They disagreed only on the methods of regulation: guilds, towns, and provinces appeared to the force of custom and tradition, while the new state authority favored statute and ordinance. But they were all equally averse to the idea of commercializing labor and land – the precondition of market economy” (ibid, p. 70).

in the economy, the presence of the market pattern was found to be compatible with it.⁸⁰ The principle of barter or exchange, which underlies this pattern, revealed no tendency to expand at the expense of the rest. Where markets were most highly developed, as under the mercantile system, they thrived under the control of a centralized administration which fostered autarky both in the households of the peasantry and in respect to national life. Regulation and markets, in effect, grew up together. The self-regulating market was unknown; indeed the emergence of the idea of self-regulation was a complete reversal of the trend of development. ... A market economy is an economic system controlled, regulated, and directed by markets alone; order in the production and distribution of goods is entrusted to this self-regulating mechanism. ... order in the production and distribution of goods is ensured by prices alone” (Polanyi 1944/1964, p. 68).

It has consequences for the state and its policy.

“Nothing must be allowed to inhibit the formation of markets, nor must incomes be permitted to be formed otherwise than through sales. Neither must there be any interference with the adjustment of prices to changed market conditions – whether the prices are those of goods, labor, land, or money. Hence there must not only be markets for all elements of industry, but no measure or policy must be countenanced that would influence the action of these markets. Neither price, nor supply, nor demand must be fixed or regulated; only such policies and measures are in order which help to ensure the self-regulation of the market by creating conditions which make the market the only organizing power in the economic sphere” (Polanyi 1944/1964, p. 69).

Market economy entails that society be subordinated to its requirements: “Market economy can exist only in a market society” (ibid, p. 71). Polanyi explains why by introducing the notion of “commodity fiction”. If commodities are empirically defined as objects produced for sale on the market, the labor, land, and money are obviously not commodities (ibid, p. 72).⁸¹ However, they, as essential elements of industry, must be organized in markets. A self-regulating market is, thus, based on the

⁸⁰ Whereas for Hayek there is no conflict between social and economic system because society delivers rules and institutions which are compatible with and underpin smooth working of market mechanism and there is no (negative) repercussion of economic system to social system, and other systems, political and social, behave and must be made to behave in accordance with market economy, Polanyi argues the other way around that the economic system must conform to the social and political system.

⁸¹ Cf. Polanyi (1944/1964, p. 72): “Labor is only another name for a human activity which goes with life itself ...; land is only another name for nature, which is not produced by man; actual money, finally, is merely a token of purchasing power which, as a rule, is not produced at all, but comes into being through the mechanism of banking or state finance. None of them is produced for sale. The commodity description of labor, land, and money is entirely fictitious.”

commodity fiction of labor, land and money.⁸² A dilemma arises for Polanyi that, on the one hand, “to allow the market mechanism to be *sole* director of [labor, land, and money] would result in the demolition of society” (ibid, p. 73). On the other hand, any policies against the formation of markets for three fictitious commodities would *ipso facto* endanger the self-regulation of the system, which endangers society in another way (cf. ibid, pp. 72-3)⁸³.

On the basis of his notion of commodity fiction, which has to be enforced by the state, Polanyi also criticized central tenets of economic liberalism, above all that of spontaneity of markets:

“There was nothing natural about *laissez-faire*; free markets could never come into being merely by allowing things to take their course. Just as cotton manufactures – the leading free trade industry – were created by the help of protective tariffs, export bounties, and indirect wage subsidies, *laissez-faire* itself was enforced by the state” (ibid, p. 139).⁸⁴

Ironically enough,

“even those who wished most ardently to free the state from all unnecessary duties, and whose whole philosophy demanded the restriction of state activities, could not but entrust the self-same state with the new powers, organs, and instruments required for the establishment of *laissez-faire*” (ibid, pp. 140-1).

Polanyi goes further to argue that “while *laissez-faire* economy was the product of deliberate state action, subsequent restrictions on *laissez-faire* started in a spontane-

⁸² Block (2003, p. 281) states in this regard: “Polanyi’s argument is that land, labor, and money are not true commodities because true commodities are things that are produced for sale on a market. Yet, the theory of market self-regulation rests on the pretense that the supply and demand for these fictitious commodities will be effectively equilibrated by the price mechanism just as if they were true commodities.”

⁸³ See also Polanyi (1944/1964, p. 130): “For a century the dynamics of modern society was governed by a double movement: the market expanded continuously but this movement was met by a counter-movement checking the expansion in definite directions. Vital though such a countermovement was for the protection of society, in the last analysis it was incompatible with the self-regulation of the market, and thus with the market system itself.”

⁸⁴ See also Polanyi (1944/1964, p. 140): “The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism. ... the introduction of free markets, far from doing away with the need for control, regulation, and intervention, enormously increased their range. Administrators had to be constantly on the watch to ensure the free working of the system.”

ous way. *Laissez-faire was planned; planning was not*” (ibid, p. 141; emphasis added)⁸⁵.

“[Economic liberals’] whole philosophy hinges on the idea that laissez-faire was a natural development, while subsequent anti-*laissez-faire* legislation was the result of a purposeful action on the part of the opponents of liberal principles” (ibid, p. 141).

“While in our view the concept of a self-regulating market was utopian, and its progress was stopped by the realistic self-protection of society, in [economic liberals’ such as Spencer and Sumner, Mises and Lippmann] view all protectionism was a mistake due to impatience, greed, and shortsightedness, but for which the market would have resolved its difficulties. The question as to which of these two views is correct is perhaps the most important problem of recent social history, involving as it does no less than a decision on the claim of economic liberalism to be the basic organizing principle in society” (ibid, pp. 141-2).

Recently, there have been attempts to clarify and elaborate Polanyi’s idea of the embeddedness or embedded economy.⁸⁶ There has crystallized a view of what Polanyi did *not* mean. That is, before the rise of a market economy the economic system was always embedded in the social system; that with its rise the situation is reversed: the social system is subsumed by the economic system of market economy; market economy becomes independent of the social system; market economy becomes dis-embedded from the social system. That is, Polanyi did not conceive that a dis-embedded market economy can exist and function.⁸⁷ There can be no such thing as self-regulating market which is, thus, utopia for Polanyi.

As Block (2003, pp. 282-3) points out;

“With this concept of embeddedness, Polanyi is challenging a core presumption of both market liberals and Marxists. Both of these traditions are built on the idea that there is an analytically autonomous

⁸⁵ See also Polanyi (1944/1964, p. 141): “The legislative spearhead of the countermovement against self-regulating market as it developed in the half century following 1860 turned out to be spontaneous, undirected by opinion, and actuated by a purely pragmatic spirit.”

⁸⁶ Cf. Barber (1995); Block (2003); Krippner (2001).

⁸⁷ Cf. Block (2003, pp. 295f.): “Polanyi demonstrates persuasively that through the whole history of market society, the strength of protection effectively embeds the economy. He suggests that functioning market societies must maintain some threshold level of embeddedness or else risk social and economic disaster.”

economy that is subject to its own internal logic. Polanyi's point is that since actually existing market economies are dependent upon the state to manage the supply and demand for the fictitious commodities, there can be no analytically autonomous economy. Furthermore, it makes no sense to speak of the logic of the market or the logic of the economy, because pretending that land, labor, and money are true commodities is both irrational and socially dangerous".

As he (Block 2003, p. 297: emphasis added) further argues:

"[Polanyi] discovers the *concept of the always embedded economy* – that market societies must construct elaborate rules and institutional structures to limit the individual pursuit of gain or risk degenerating into a Hobbesian war of all against all. In order to have the benefits of increased efficiency that are supposed to flow from market competition, these societies must first limit the pursuit of gain by assuring that not everything is for sale to the highest bidder. They must also act to channel the energies of those economic actors motivated by largely by gain into a narrow range of legitimate activities. In summary, the economy has to be embedded in law, politics and morality."

In criticizing the thesis that economic growth leads to political stability, which is held by many scholars and policy-makers concerning US foreign aid policy, Olson (1963, p. 531) argued that rapid economic growth is socially and politically "a profoundly destabilizing force". This is because rapid economic growth weakens the traditional bonds of class, caste and even family or clan.⁸⁸ Due to the social dislocation that is entailed by rapid economic change gainers as well as losers, in economic terms, can be destabilizing forces. For Olson the social dislocation is represented by "contradiction" between new distribution of economic power and old distribution of social prestige and political power. His general conclusion is quite Polanyian in nature: "The economic system, the social system, and the political system are obviously interdependent parts of a single society, and if one part changes quickly, there must be also be instability in other parts of society" (Olson 1963, p. 533).

⁸⁸ Cf. Olson (1963, pp. 532-3): "The replacement of subsistence agriculture and cottage industry, normally organized around the family, with factory production by workers hired individually, can weaken family ties. Similarly, modern business institutions are bound to weaken or even to destroy the tribe, the manor, the guild, and the rural village. The uprooted souls torn or enticed out of these groups by economic growth are naturally susceptible to the temptations of revolutionary agitation."

On the basis of this connection between rapid economic growth and political instability Olson (1963, pp. 550-1) argued for the necessity of services of modern welfare state in the underdeveloped countries:

“It is no doubt that the underdeveloped countries cannot afford modern welfare measures as well as the advanced nations can. But it is perhaps also true that they need these modern welfare institutions more than the advanced countries do. These welfare measures, though they might retard growth, could nonetheless be a profitable investment in social peace. They could ease the plight and alleviate the discontents of those who lose from economic growth”.

Olson (1963, p. 551) appreciated in this context Karl Polanyi’s contribution:

“Polanyi was, in my opinion, quite correct in emphasizing that the relative merits of alternative economic policies had not been decided when it was shown that one led to a faster rate of growth than the others. The differing impacts of capitalistic and socialistic economic systems on the political and social life of a society also had to be considered. Polanyi felt that, while laissez-faire capitalism led to a high rate of growth, it imposed too great a burden of adjustment on society”.⁸⁹

In a certain sense, it could be argued that Hayek did not overlook what economic progress requires and what (social) sacrifice it involves (probably due to the necessity of constructing his theory on the basis different from neoclassical economics rather than because of his ‘social conscience’). However, for Hayek, social dislocation or degradation is not merely an inevitable concomitant of economic progress and growth of civilization but moreover their requirements. As shall be shown below (Ch. 6), Hayek did not even acknowledge the existence and problem of social dislocation or ‘alienation’ in an extended and complex order, which capitalism is. According to Hayek, dislocation or alienation stems rather from misunderstanding of the nature and ‘working mechanism’ of spontaneous orders and of social evolution and has thus no real content (cf. Hayek 1988, FC, p. 64 and pp. 153-3).

⁸⁹ Olson (1963, p. 551) qualified Polanyi’s argument by maintaining that the social disorganization resulting from economic change cannot be identified with capitalism alone, but applies to socialism as well demonstrated by painful adjustments to rapid economic growth due to Stalin’s first five-year plan.

Polanyian embeddedness and varieties of capitalism

Polanyian insights are now attracting increasing attention, utilized and further developed to criticize theory and policy offered by mainstream economics. They are used as an argument of warning against globalization. They also provide theoretical basis for ‘varieties of capitalism’⁹⁰, which implies at the fundamental level to question the idea of the absolute superiority of free market economy (represented by Anglo-American capitalism) over the other forms of market economy in terms of economic efficiency on account of which it will outlive welfare state or market economies which have different approaches to market mechanism and non-market institutions. Literature on varieties of market mechanism demonstrates that there can be various ways of ‘running’ the market mechanism given different historical and social contexts, that markets are embedded in these contexts in one way or another and that there are relative strengths and weaknesses in different types of capitalism but no absolute superiority of one type over the other such that different types will converge on the one superior type (of Anglo-American capitalism). In a nutshell, this approach argues that there is no analytically separated realm of the economic (or market economy) from that of the social (non-market institutions) and that in the long run continual mismatch between the economic and the social is not sustainable. Thus, whereas short-term economic efficiency and flexibility explain relative strength of Anglo-American capitalism, long-term social coherence and ecological sustainability cannot be expected: In other words, if convergence, or even survival, can only be viewed as a possible outcome of long-term (evolutionary) process, one cannot rule out that Anglo-American capitalism can deteriorate or fail on account of ‘short-termism’.

Empirically there are various ways of organizing markets. This is understood as representing different ways of embedding market economy in different social and historical contexts. According to this reasoning even Anglo-American capitalism is institutionally and socially embedded, albeit differently from other types of capital-

⁹⁰ Cf. Albert (1993); Hollingsworth and Boyer (eds.)(1997); Crouch and Streeck (eds.)(1997).

ism in continental Europe and East Asia.⁹¹ While it is admitted that every market economy must be understood in terms of embeddedness, which might be interpreted as ‘operationalization’ of Polanyian insights in a modern and wider context,⁹² the underlying tenor of the literature is that capitalism has an inherent tendency to dis-embed, undermine its own institutional and social bases, which leads to serious consequences if not coped with and counterbalanced by policy measures. As Hollingsworth (1997, p. 133) argues:

“Capitalism is contradictory, undermining the institutions essential for its continuation. Historically, a variety of social and political institutions have contained the destructive forces of capitalism, keeping firms in harmony with society, but the weakening of existing modes of regulation has recently created serious problems in American capitalism”.

From the perspective of ‘varieties of capitalism’ varieties are attributed to economy being embedded in different historical, social and institutional contexts.⁹³ It offers a holistic view of how market economies are differently ‘organized’ in different societies and of how economic and non-economic spheres in human life are so interrelated that it is misleading, even futile, to conceive the ideal working of a market economy as if either social and institutional contexts do not matter (neoclassical self-regulating (or autonomous) market) or, if they matter, only insofar as they underpin an ideal working of market economy (Hayekian Free Market). It is a Polanyian insight that

⁹¹ Hollingsworth (1997, p. 133) argues that “the distinctive configuration of American capitalism has evolved over a long period and has a logic to its institutional evolution; that the dominant forms of governance of the American economy have been private hierarchies, markets, and the state, with associations being very weak; that variation in governance forms has made for varying performance of industrial sectors over time; that American economic institutions are part of a larger institutional context, and therefore are unlikely to converge with the configuration of capitalism elsewhere; and that the dynamism of American capitalism, with its heavy emphasis on a market mentality and widespread inequality in income distribution, threatens to erode the institutions which have, historically, shaped it.”

⁹² Whether the idea that market economy is always embedded can be inferred from the work of Polanyi is still controversial, especially among socialists. This must not, however, detain us here. I would argue that the idea can be seen at least as a generalization and further refinement of Polanyi’s work.

⁹³ This applies also to American capitalism. Cf. Hollingsworth (1997, p. 134): “Unlike nations with aristocratic traditions, Americans have historically highly valued entrepreneurship. American Puritanism provided spiritual legitimation for the virtues of enterprise, which, combined with the weakness of traditional communities, partly explains why Americans had a weakly developed civil society”; Hollingsworth (1997, p. 141): “The dominant social system of production in American society was historically coordinated by markets and corporate hierarchies, with firms embedded in a weakly developed society.”

an analytically separated market economy cannot be conceived and, therewith, an ideal working of market economy (mostly conceived as a full and free play of the price mechanism based on demand and supply). Different social and institutional contexts affect different societies in one way or other. Even if they do not change the nature of capitalism, they modify the working of market mechanism to a more or less degree in different societies through policy measures regulating supply and demand of labor, housing, etc. If American capitalism gives relatively more leeway to full and free play of the market, it is not to be interpreted as the result of approaching more closely to the ideal, but as the product of social and institutional contexts. This explains both strengths and weaknesses of American capitalism (cf. Hollingsworth 1997, p. 146).⁹⁴

Whether one conceives an ideal working of market economy independently of social and institutional contexts has a more fundamental consequence. It is connected with the view that incorporating different social and institutional contexts into the market economy amounts to illegitimate interferences with the (ideal) working of market economy, which leads to undermine it in the end. In contrast, from a Polanyian perspective there are only and always modified workings of the market mechanism (to different extents) such that attempts to implement an ideal market economy, in reality, themselves require interferences which run counter to different social and institutional (and cultural) contexts.

⁹⁴ Cf. Hollingsworth (1997, p. 146): “The social environment plays an important role in shaping the behavior of firms, their types of products and their production strategies. If firms are embedded in an institutional environment rich in collective goods, flexible systems of production in more traditional industries are likely to be dominant. But in a society where there is a lack of such an environment, the market mentality becomes more important, and the collective goods necessary for the flexible production of high quality products and for international competitiveness in more traditional industries are lacking. On the other hand, precisely because American firms are not embedded in a rich institutional environment, they are extraordinarily adaptable, which has given them a distinct advantage in newer sectors that emphasize individualism and creativity and that have a need for well-developed venture capital markets. At the same time, underneath all the glamour of the new industries in the American economy, the institutional underpinnings requisite for sustaining a vibrant economy and a high degree of civility remain extremely weak. The long-term prognosis for American capitalism is therefore problematic ...”

Polanyian embeddedness and National systems of innovation

The idea of ‘Varieties of capitalism’ is also related to ‘national systems of innovation’. It shows that according to different social, historical and cultural contexts even technological advance and innovation, which are regarded as core competence of capitalism marking its superiority over socialism, develop differently and are organized differently in different societies. It represents systemic and holistic approach to innovation process beyond the narrow focus on R&D and on high tech and science-based innovations (cf. Lundvall et al. 2002). In this perspective innovation is understood as interactive learning within and between agents and organizations such as firms, universities, the state, etc.⁹⁵ The interactions must involve non-price relationships which can be presented as “organized markets with elements of power, trust and loyalty” (Lundvall et al. 2002, p. 218). Organized markets and processes of interactive learning can be established differently in accordance with different national contexts. Trust, long-term relationships and social cohesion loom large for not all knowledge can be codified in universally comprehensible form which can be globally and instantly transmitted, but tacit knowledge which is embedded in individuals, organizations and localities plays an important role. Hence, the importance of institutions which are different from society to society: “Institutions understood as norms, habits and rules are deeply ingrained in society and they play a major role in determining how people relate to each other and how they learn and use their knowledge” (Lundvall et al. 2002, p. 220). In the context of an innovation system the time horizon of agents, the role of trust and the actual mix of rationality are the most important aspects of institutions (ibid.). Lundvall et al. (ibid, p. 225) point to “contradictions inherent in the economic process that threaten learning and competence building by undermining social capital”. They argue further:

“Competition depends more and more on dynamic efficiency rooted in knowledge or knowledge related resources with long-term characteristics. These resources often take long time and sustained

⁹⁵ See Lundvall et al. (2002, pp. 225-6): “Innovation systems work through the introduction of knowledge into the economy (and into the society at large). It requires active learning by individuals and organizations taking part in processes of innovation of different kinds. The efficiency of these learning activities and, hence, the performance of the innovation systems depends on economic, political and social infrastructures and institutions. It also depends on past experiences as they are reflected in the tangible and intangible aspects of the structure of production and on values and policies.”

efforts to build but they may also be quickly destroyed. This is because learning and innovation are interactive processes, which depend on trust and other elements of social cohesion” (ibid, p. 225).

This is equally true for natural capital:

“One problem is that the speed-up of change puts a pressure on all kinds of established social relationships in local, regional and national communities. It contributes to the weakening of traditional family relationships, local communities and stable workplaces. This is important since the production of intellectual capital (learning) is strongly dependent on social capital. To find ways of re-establishing the social capital undermined by the globalization process is major challenge” (ibid, p. 225).

Though they do not refer to Karl Polanyi their arguments are quite Polanyian in nature, especially when Lundvall (1998) tries to establish ethical dimension in the economy with the notion of learning economy. Drawing on Arrow he argues to the effect that social capital (trust) is indispensable for the working of market economy but cannot be produced and provided by the market. Trust and absence of opportunistic behavior can considerably reduce transaction cost but trust cannot be bought or produced for that purpose:⁹⁶ “You cannot buy trust – and if you could buy it, it would be of no value whatsoever” (Arrow 1971, quoted from Lundvall 1998, p. 47). This leads Lundvall (ibid.) to state:

“Given that trust is necessary in order to make the economy work – and this is true for any trade in information and it is even more true in connection with processes of interactive learning – it becomes clear that there must be something outside the pure instrumental rationality of individual agents to keep the economy together.”

In the context of ‘knowledge society’ or ‘learning economy’ trust and cooperation will be even more important since tacit or implicit knowledge is typically transferred and shared not through market mechanism but through a process of interactive learning. Lundvall (1998, p. 48) argues in this regard:

“This implies that the more an economy becomes dependent on the formation and efficient use of knowledge the more important its ethical foundations become. This points to a fundamental contra-

⁹⁶ I would argue that trust (or social capital) can be categorized as a fourth victim of commodity fiction to which Polanyi counted labor, land and money.

diction in the modern economy. There are strong tendencies towards generalizing the market and letting it penetrate more and more deeply into all kinds of relationships. Today this is reinforced especially by the globalization and deregulation of financial markets which tend to undermine all kinds of non-market regulations and relationships at the national level. But economies where the market loses its roots in the social system and where all agents act exclusively on the basis of strategic and instrumental rationality will find that their capacity to learn and innovate will become undermined.⁹⁷ ... Building formal institutions and introducing new laws will not help much if the social foundations are absent.”

As demonstrated above, underlying varieties of capitalism literature and national systems of innovation is the view that there is no standard model of how capitalism should be run or how a market economy ought to work. According to this reasoning that there exist different types of capitalism is an empirical fact which must be explained and taken into account, but which cannot be defined away by establishing one as the standard and the others as deviation from it when constructing theories of social sciences in general and economics in particular. In British and American type institutions and economic behavior patterns most closely conform to the prescriptions of mainstream economics whereas in German and Japanese types institutions most significantly deviate from them (cf. Dore et al. 1999).⁹⁸ Comparing development of capitalist economies in the 20th century Dore et al. (1999, p. 102) argue that “there is no obvious story of a long and steady process of gradual convergence – capitalist rationality slowly washing out the effects of differing cultural traditions”, that no firm prediction can be made as to converge or remain diverse in the future.

What the “varieties of capitalism” literature shows is that narrower conformity to the accounts of neoclassical economics does not establish the Anglo-American type as a

⁹⁷ From this view Lundvall (1998, p. 48) derives the need for social policy: “A society which does not care for its weaker citizens will have difficulties in maintaining and fostering a social climate of trust and acceptance”, which makes up social foundations for economic growth. In this context Lundvall proposes “ex-ante approach” of combining social and innovation policies in such a way that access of weaker groups to learning and networking is supported and fostered.

⁹⁸ See Dore et al. (1999, p. 117): “Japan and Germany remain very different. Japan’s economic institutions are deeply *socially* embedded, in spite of a legal framework – company law, for instance – hardly different from that of Anglo-Saxon countries. By contrast, Germany’s system derives its strength from its firm legal entrenchment. The crucial capital-labor relation is seen in Germany as a clear and conscious class compromise in a situation of structural antagonism. In Japan it is fragmented within community-like corporations, where managers identify more closely with their workers than with the providers of their capital. The systems differ, but they both produce economic behavior and value priorities that continue to be very different from those of the Anglo-Saxon economies.”

model nor substantiates its absolute superiority over the other types and that if economic efficiency is understood in a broader term including social and ecological sustainability and in long-term perspective, one cannot say that the Anglo-Saxon is the most efficient of all.

Varieties of capitalism arise from embeddedness, from the fact that market economy is embedded in different historical, social, cultural, in a word, institutional contexts of different societies. Varieties are reflected in and penetrate all spheres of human life, economic, political and social. Hence, varieties even in technological development and innovation, the core competence of capitalism, which is demonstrated by national systems of innovation literature. Different forms of corporate control or governance⁹⁹ (shareholder vs. stakeholder principle¹⁰⁰), different configurations and roles of banking and financial system, different legislations and regulations with regard to labor market, different relevance of internal vs. external labor market, different extent of social security system are all interrelated features of varieties stemming from different forms of embeddedness.

⁹⁹ Cf. Nooteboom (1999).

¹⁰⁰ Cf. Lazonick and O'Sullivan (2000).

Excursus: Polanyian embeddedness and theory of Social Market Economy¹⁰¹

Insights from Polanyian embeddedness and the “varieties of capitalism” literature¹⁰² and also from Lundvall¹⁰³ are similar to those of Müller-Armack’s theory of SME. For Müller-Armack the market economy is based on value systems which cannot be provided by the market itself.¹⁰⁴ In Müller-Armack’s works (especially relating to sociology of religion) one can find many arguments indicating ‘varieties of capitalism’ and national systems of innovation. His concept of economic (or culture) style (*Wirtschaftsstil* or *Kulturstil*)¹⁰⁵ means a concept of interrelationship between eco-

¹⁰¹ It is beyond the scope of this dissertation to deal in detail with the German theory of Social Market Economy which was crucially developed by Müller-Armack who also coined the term *Soziale Marktwirtschaft*. For a concise overview see Müller-Armack (1965 and 1978). It must also be pointed out that in spite of their common origin and mutual influence there are some important differences as well as similarities between Müller-Armack’s approach to Social Market Economy and the (ordoliberal) approach of the Freiburg school, as represented by Walter Eucken and Franz Böhm. On the Müller-Armack’s theory of Social Market Economy see Watrin (2000) and Katterle (2000). For the ordoliberal version of Social Market Economy see Schmidtchen (1984) and Vanberg (1988). For the ‘de-homogenization’ of two closely related but distinct approaches see; Zohlnhöfer (2000) and Kulesa and Renner (1998). The latter are highly critical of Müller-Armack’s theory of SME compared to the Freiburg school approach.

¹⁰² Cf. Müller-Armack, (1940-4/1959, p. 58; my translation): “The organization of market, the banking and credit system, the forms of accounting system of firms, the finance of state and churches, the forms of household and the types of satisfying demand, in short, all spheres of the social and the economic obtain from the new historical stamp [*Prägung*] also a new meaning.” See also Müller-Armack (1940-4, p. 192; my translation): “What Adam Smith formulated in 1776 in his book *Wealth of Nations* was neither in terms of matter nor in terms of form really new. His work did not mark the foundation of the idea [economic liberalism], but can merely be assessed as end of a development which ceased being a country-specific phenomenon after the international success of his book. Without Calvinism the *liberalization of the entire life* which took place in the Netherlands since 16th century and in England since 17th century would be incomprehensible. As a movement which in the Netherlands and England had to establish itself in struggle against strata of different faith, Calvinism led immediately to demanding religious tolerance. The demand for political and economic freedom, which was raised later, was its significant supplement. For economic freedom was also the sole guarantee of religious independence for strata that were excluded from public offices due to their faith. That was forced by conjunction of the spheres of life and was no fabrication according to interests.” Irrespective of whether Müller-Armack’s reading of Adam Smith is right, this passage reveals his view that liberal market economy is only possible in a liberal society.

¹⁰³ Though he focuses on the Spiethoff’s approach to economic style rather than on Müller-Armack’s Ebner (1999) makes attempts to demonstrate that the conception of economic style which stems from the research tradition of German Historical School is useful to analyze national systems of innovation.

¹⁰⁴ Cf. Müller-Armack (1952, especially p. 235).

¹⁰⁵ According to Müller-Armack, economics has taken the notion of style from the observation in culture. When one e.g. speaks of a Rococo style, it means the specific of the artistic impression that shows itself in all manifestations and works of this style. Thus, “*Style is the unity of expression and attitude which is visible in the most various spheres of life of a period*. In the same sense we speak of *economic style* [*Wirtschaftsstil*], where the manifestations in the area of the social and the economic exhibit the expression of uniform imprints” (Müller-Armack 1940-4, p. 57; my translation and italics in the original). For an overview of the concept of economic style in the German research tradition see Schefold (1994).

conomic and non-economic spheres which can be best understood in terms of Polanyian embeddedness.¹⁰⁶

In this perspective, in contradistinction to Hayek, Müller-Armack argues that:

“The past economic systems must not be understood from the perspective of a natural process which takes its course beyond the grasp of human control, but they are themselves results of shaping [*Gestaltung*] by the people of their time” (Müller-Armack 1940-4, p. 60; my translation).

From his conception of SME as an economic style Müller-Armack comes to instrumentalist view of the market (cf. Müller-Armack 1946).

His theory of SME as an economic style implies no less than embedded economy in terms of Polanyi.¹⁰⁷ It is due to misunderstanding or ignoring this perspective that there is a continuing debate (mostly in German literature) about the meaning of the adjective ‘social’ in *Social Market Economy*.¹⁰⁸

Substantive embeddedness vs. formal embeddedness

While all market economies are embedded in one way or another, based on non-economic institutions, the forms of embeddedness are different.¹⁰⁹ I would classify them as either loose-embeddedness or tight-embeddedness. Loose-embeddedness means that there is more leeway for and less regulation of market mechanism (which I would call Free Market Economy: FME). Tight-embeddedness means the reverse (which I would call Social Market Economy¹¹⁰: SME). But they both amount to sub-

¹⁰⁶ In Müller-Armack’s framework identifying different economic styles has three dimensions: *Firstly*, within an economic style it means given unity of style (*Stileinheit*) explaining interrelationship between various sphere of life as a unity and not apart; *Secondly*, it means explaining why different countries or zones come to develop different styles which include (in my view) different institutions both in formal and informal sense; *Thirdly*, it explains historically the rise and demise of economic styles. It can be said the whole amounts to cross-sectional and longitudinal study of economic styles. All these three dimensions must be appreciated in order to understand his theory of economic style and more generally his theory of SME.

¹⁰⁷ It must be noted, however, that Müller-Armack’s emphasis on the guiding role of religion and *Weltanschauung* may come into conflict with Polanyi’s view.

¹⁰⁸ Cf. Gutowski and Merklein (1985); Lampert and Bossert (1987); Witt (2000).

¹⁰⁹ See below Ch. 7 and diagram there.

¹¹⁰ This must not necessarily refer to Müller-Armack’s theory or German Social Market Economy. It can also refer to ‘negotiated economy’, e.g., insofar as and to the extent that substantive embeddedness is implied.

stantive-embeddedness in that they are based on different social, moral and cultural foundations that, whether ‘loosely’ or ‘tightly’ influence and embed the economic process ‘substantively’. Hollingsworth’s interpretation of institutional embeddedness of American capitalism can be seen as explaining loose-embeddedness whereas German and Japanese types represent tight-embeddedness. Substantive-embeddedness implies that there is no ideal or standard working of market economy which must not be interfered with but there is only and always ‘embedded’ working of market economy which is modified and underpinned by different social and cultural contexts. Relative strengths and weaknesses of different types result from differences in embeddedness. Substantive-embeddedness means that there are not only positive but also negative feedbacks between the economic and non-economic spheres, that change in one sphere necessarily leads to change in the other sphere, which implies that configurations of embeddedness change over time but embeddedness must be retained. From a Polanyian viewpoint which argues the primacy of the social over the economic, every economic change must be so managed to avoid social disintegration or dislocation.¹¹¹ In the perspective of substantive embeddedness there has been, and will be, vicious as well as virtuous interrelation between market and non-market institutions and mismatch as well match between them as economy grows and technology advances.¹¹² Thus, especially negative repercussions of the market economy to its social and moral foundations must be emphasized and counterbalanced by policy measures, which is described as countermovement of society by Polanyi. It is important to note that for Polanyi countermovement aiming at embedding a market economy is, in contrast to Hayek, a *spontaneous* process and must not be understood as interference from without but underpinning from within.

From this substantive-embeddedness I distinguish formal-embeddedness, which means that morals and institutions matter insofar as they conform to an ideal working of market economy and do not embed the latter in the substantive sense. Though it is

¹¹¹ Lundvall’s learning economy can be understood also in this spirit, when he says: “The assumption that more competition and wage flexibility is the key to solving the problem of unemployment neglects the fact that learning is a social process which can prosper only if society remains cohesive. The impact on the social and moral foundations of society must be taken into account by any policy aiming for long-term economic efficiency” (Lundvall 1998, p. 51).

¹¹² Cf. Gray (1998, pp. 146ff.); Hirschman (1977 and 1986).

recognized that for the working of market economy institutional foundations are indispensable, they have no substantive role of modifying the working of market economy. In the context of formal-embeddedness, if there is a conflict between economy and society, the latter must be 'reformed' to adjust itself to the former, not the other way round. In the next chapters I shall try to demonstrate that Hayek's theory of FME can be interpreted as an attempt, firstly, to establish FME in the context of formal-embeddedness (with institutional arguments) and, secondly, to claim its universal validity and superiority in the context of substantive embeddedness (with evolutionary arguments). I shall argue that Hayek failed in his attempt in this regard.

3. Institutional Dimensions

I have argued above (Ch. 1) that Hayek could not solve his *knowledge problem* in the end, that Hayek's recourse to price system with competition as *the* instance of coordinating dispersed and tacit knowledge (*knowledge argument*) begs more question than answers. In spite of his qualification of neoclassical equilibrium construct by redefining it he could not show how disequilibrium prices can coordinate the market economy. This is a part of the dilemma which accompanied Austrian economics from the beginning as Vaughn (1999, p. 129) points out:

"From Menger to the present day, economists working in the Austrian tradition have displayed an ambivalent attitude toward the use of equilibrium constructs in economic analysis. On the one hand, they have repeatedly argued that economics should be primarily concerned with explaining economic processes that generate spontaneous economic orders. On the other hand, they have been reluctant to attempt to explain market processes without reference to some more or less standard notion of equilibrium to ground the analysis."

For Hayek tendency toward (economic) equilibrium is an empirical fact. But economy is most of the time not in the state of equilibrium and as Hayek argued neoclassical theory's excessive focus on the equilibrium state is meaningless. But economic processes adapting to changes lead to a sort of equilibrium rather than disequilibrium because of the tendency toward equilibrium. It follows that prices are most of the

time disequilibrium prices but contribute to equilibrating the economy. However, “the problem of what information is conveyed by non-equilibrium prices” remains (Vaughn 1999, p. 134).

Some questions arise in this context: If Hayekian tendency to equilibrium has done its job, would the end-state look different from the equilibrium state conceived by neoclassical economics? Does Hayek’s theory merely describes the processes through which neoclassical equilibrium is being achieved, there being no difference between the end-states which Hayek and neoclassical economists conceive respectively? Do the processes not change the nature of the end-state? They are legitimate questions insofar as Hayek made some remarks which could be interpreted as suggesting that the results are qualitatively equivalent but the result which neoclassical equilibrium is supposed to bring about is unattainable under real conditions and that an approximation to it which is only feasible in reality can be reached only by the real market process, which is ignored by neoclassical economics.

“As in the biological organisms we often observe in spontaneous social formations that the parts move as if their purpose were the preservation of the wholes. We find again and again that *if* it were somebody’s deliberate aim to preserve the structure of those wholes, and *if* he had knowledge and the power to do so, he would have to do it by causing precisely those movements which in fact are taking place without any such conscious direction.” (Hayek 1952/1979, CRS, p. 145).

“It must not be forgotten that in this respect the market only brings about an approach towards some point on that n-dimensional surface, by which pure economic theory represents the horizon of all possibilities to which the production of any one proportional combination of commodities and services could conceivably be carried. ... A mind knowing all the facts could select any one point he liked on the surface and distribute this product in the manner he thought right. But the only point on, or tolerably near, the horizon of possibilities which we know how to reach is the one at which we shall arrive if we leave its determination to the market” (Hayek 1968, pp. 185-6).

A more fundamental problem is that the tendency to equilibrium can only work if the economy is in the state of ‘near-equilibrium’. This was also acknowledged by Hayek not in terms of equilibrium but in terms of order (cf. Fleetwood 1996; Vaughn 1999).

Order as Equilibrium or Order without Equilibrium

In his later works Hayek preferred the term order to equilibrium. This does not necessarily mean that he wholly abandoned the notion of equilibrium, whether neoclassical or not.¹¹³ He did not deny that there is some affinity between the two notions, but endeavored to distinguish the one from the other:

“Economists usually ascribe the order which competition produces as an equilibrium – a somewhat unfortunate term, because such an equilibrium presupposes that the facts have already all been discovered and competition therefore has ceased. The concept of an ‘order’ which, at least for the discussion of problems of economic policy, I prefer to that of equilibrium, has the advantage that we can meaningfully speak about *an order being approached to various degrees*, and that order can be preserved throughout a process of change. While an economic equilibrium never really exists, there is some justification for asserting that the kind of order of which our theory describes an ideal type, is approached in a high degree” (Hayek 1968, p. 184; italics added).

After he criticized the neoclassical notion of equilibrium with its accompanying assumptions of perfect knowledge and perfect competition, he needed a notion which can embrace his argument of knowledge and competition and which is not restricted to the economic sphere but can be expanded to the society as a whole. This notion must be of the nature of a ‘low-profile’ approach which avoids a ‘absolutist’ approach as is represented by the neoclassical terms of ‘perfect’ (knowledge and competition), ‘general’ (equilibrium) and ‘optimal’ (Pareto Optimality). Hayek’s twin ideas of spontaneous order and cultural evolution were attempts to refine his knowledge argument and to extend it to the overall order which encompasses the social and political sphere as well as the economic (see below and Ch. 4).

I have above dealt with Hayek’s critique of the neoclassical general equilibrium and with his attempt to reconstruct it from a tautological Pure Logic of Choice (of an individual) to a societal equilibrium whose affinity with Hayek’s order in his own definition cannot be overlooked:

¹¹³ Even in Hayek (1973, p. 63 and p. 66)) he used the term equilibrium.

“By ‘order’ we shall throughout describe *a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct.* It is clear that every society must in this sense possess an order and that such an order will often exist without having been deliberately created” (Hayek 1973, LLL 1, p. 36; italics in the original).

Successful interaction and cooperation between individuals who pursue their own aims and try to satisfy own needs is only possible in case of the correspondence of expectations concerning the actions of others on which our plans are based with what they will really do: “This matching of the intentions and expectations that determine the actions of different individuals is the form in which order manifests itself in social life” (ibid, p. 36). As we remember, the matching of subjective data of the individuals (with each other and) with objective facts is Hayek’s definition of societal equilibrium. How such an order comes about is for Hayek a fundamental question which he try to address with his theory of spontaneous order and cultural evolution.

Market as a Spontaneous Order

Hayek’s theory of spontaneous order is closely interrelated with his theory of social or cultural evolution as Hayek himself termed them as the “twin ideas of evolution and of the spontaneous formation of order” (Hayek 1966b, p. 250; Hayek 1967a, p. 77; Hayek 1988, FC, p. 146) to which firstly Mandeville and then Scottish moral philosophers such as David Hume, Adam Smith and Adam Ferguson¹¹⁴ made substantial contributions (Hayek 1973, LLL 1, pp. 20ff.). Hayek summarized Mandeville’s main insights on this regard as follows¹¹⁵:

“His [Mandeville’s] main contention became simply that in the complex order of society the results of men’s actions were very different from what they had intended, and that the individuals, in pursuing their own ends, whether selfish or altruistic, produced useful results for others which they did not anticipate or perhaps even know; and, finally, that the whole order of society, and even all that we call culture, was the result of individual strivings which has no such end in view, but which were chan-

¹¹⁴ For a critique of Hayek’s understanding of Adam Ferguson see Oz-Salzberger (1998).

¹¹⁵ There are also various interpretations regarding Mandeville, some of which corroborate Hayek’s reading and others not. See Viner (1953); Rosenberg (1963); Rashid (1985); Irwin (1991, pp. 21-24).

neled to serve such ends by institutions, practices, and rules which also had never been deliberately invented but had grown up by the survival of what proved successful” (Hayek 1966b, p. 253).

That is, on the one hand social orders arise, or form itself, spontaneously as the result of individuals submitting to rules within the given institutional and cultural context while pursuing their own ends or purposes. On the other hand, the beneficial character of this order depends on the nature of rules which are ‘provided’ by evolutionary selective process. While the two ideas are closely interrelated, they can be separated for analytical purpose. We first deal with his theory of spontaneous order. His theory of cultural evolution and more detailed assessment of the ‘twin ideas’ will follow in the next chapters 4 and 5.

Spontaneous Order vs. Organization

For Hayek there are two kinds of order: spontaneous order and organization. The former Hayek referred to also as grown, self-generating, endogenous order or cosmos (*kosmos* in Greek) and the latter as made, exogenous order, or arrangement or *taxis* in Greek. To the first category belong market, money and law, and to the latter, above all, the government (which Hayek prefers to the term ‘the State’) and the firm but also the family, the farm, the plant. To distinguish the former from the latter is “indispensable for any understanding of the processes of society as well as for all social policy” (Hayek 1973, LLL 1, p. 37).

Spontaneous orders arise as “the result of their elements [individuals] following certain rules in their responses to their immediate environment” (ibid, p. 43). Organizations serve a purpose of the maker and are simple and concrete: their complexity is confined to such a low degree as the maker can master and their existence can be intuitively perceived by inspection. In contrast, spontaneous orders are based on “purely abstract relations which we can only mentally reconstruct,” and have no particular purpose and can achieve a high degree of complexity (ibid, p. 38f.).

Hayek’s main contention in this regard is that “very complex orders, comprising more particular facts than any brain could ascertain or manipulate, can be brought about only through forces inducing the formation of spontaneous orders” (ibid, p. 38)

or that the spontaneous order “will always be an adaptation to a large number of particular facts which will not be known in their totality to anyone” (ibid, p. 40). His theory of spontaneous order is then no more than a generalization of his argument for the market economy which enables the best possible utilization of “knowledge of the particular circumstances of time and place” which is not given to anyone as a whole. In a market economy the coordination of different knowledge of different individuals into a coherent whole is achieved by the price system as a “system of telecommunications” such that individuals do not have to care about all the details and particular facts but only have to know the prices relevant for their decisions (Hayek 1945b; see above). The controversy of market economy or socialism is now generalized into that of spontaneous order or organization. For Hayek socialism is nothing other than transformation of the overall spontaneous order of society, of which market order is the most important component, into the organization.

Just as the price system and competition in a market economy help individuals adjust themselves to the particular circumstances that are known only to them respectively and to their unforeseen changes while exploiting their own knowledge, the rules in spontaneous orders coordinate actions of the individuals responding to their immediate environment while pursuing their own ends utilizing their respective knowledge.

Hayek seems to suggest that by demonstrating the existence of spontaneous orders and by explaining certain features which they must possess (complex and abstract) and benefits which follow from these features (utilization of knowledge and adaptation to unforeseen changes) he also demonstrated the existence of spontaneous ordering forces with which we must not interfere if we want to benefit from spontaneous orders. Hayek circumvented the difficulty of explaining the spontaneous ordering force itself by giving some examples of spontaneous orders which can be found in nature.

“In the familiar school experiment in which iron filings on a sheet of paper are made to arrange themselves along some of the lines of force of a magnet placed below, we can predict the general shape of the chains that will be formed by the filings hooking themselves together; but we cannot predict along which ones of the family of an infinite number of such curves that define the magnetic field these

chains will place themselves. This will depend on the position, direction, weight, roughness or smoothness of each of the iron filings and on all the irregularities of the surface of the paper. The forces emanating from the magnet and from each of the iron filings will thus interact with the environment to produce a unique instance of a general pattern, the general character of which will be determined by known laws, but the concrete appearance of which will depend on particular circumstances we cannot fully ascertain” (Hayek 1973, LLL 1, p. 40).

This is sufficient for Hayek to assert that:

“By relying on the spontaneous ordering forces, we can extend the scope or range of the order which we may induce to form, precisely because its particular manifestation will depend on many more circumstances than can be known to us – and in the case of a social order, because such an order will utilize the separate knowledge of all its several members, without this knowledge ever being concentrated in a single mind, or being subject to those processes of deliberate coordination and adaptation which a mind performs” (Hayek 1973, LLL 1, pp. 41-2).

Just as Hayek did not explain how the price system can work as a “system of telecommunications” and how the knowledge problem can be solved by it, Hayek seems to suggest that rules, if followed generally, will give regularity to actions of individuals which is a prerequisite of an overall order. So long as rules are followed, the general character of a spontaneous order as such, that is, as consisting of abstract relations, will be preserved. If individuals follow ‘appropriate’ rules, a overall order will form itself spontaneously while they respond to the particular circumstances which affect them differently and whose relevance is thus different to different individuals in their own way using their different knowledge. Thus what we can know, according to Hayek (1973, LLL 1, pp. 39-46), is only the general character of a spontaneous order by its rules but not the detail of that order (its “particular manifestation”).¹¹⁶ Thus seen, Hayek’s ‘spontaneous ordering forces’ boil down to individuals following those rules that lead to the spontaneous formation of an overall order. Its general (abstract) character will be determined by the character of rules, but the detail or “particular content” of the order will depend on the response of different individuals to particular facts which are known to them respectively but not known to

¹¹⁶ Cf. Hayek (1973, LLL 1, p. 41): “Since we can know at most the rules observed by the elements of various kinds of which the structures are made up, but not all the individual elements and never all the particular circumstances in which each of them is placed, our knowledge will be restricted to the general character of the order which will form itself.”

anybody in their totality.¹¹⁷ Thus if the general character is preserved, the order represents a coherent whole (or ‘accumulation’ if you will) of individuals’ adaptations to a larger number of particular facts than can be mastered by any single individual.

For Hayek a most important consequence of preserving the ‘general character’ of a spontaneous order, which will be determined by the regularity of the conduct of the individuals, is that we can neither predict or determine the particular position of individuals (or groups) or relation between particular individuals (or groups)¹¹⁸, which is only possible in an organization which makes use of deliberate arrangement. This is tantamount to saying that if we are to benefit from a high degree of complexity, which means that as a whole more knowledge can be utilized and more particular facts can be taken into account in a society as an overall order, we must rely on spontaneous ordering forces and must resign ourselves to the loss of power of control over the complex order: we cannot determine relative positions of individuals or alter them according to our desires without “interfering with” and thus “impeding” the forces producing the spontaneous order (Hayek 1973, LLL 1, pp. 41-2): Individuals must understand and accept different positions and their unforeseen changes as a working mechanism of spontaneous ordering forces and their outcome. As I shall show below (Ch. 6), this is one argument of Hayek against social (or distributive) justice in a market order as a spontaneous order: we cannot determine or alter relative economic positions of individuals or groups and their changes (above all unexpected descent of relative income of certain individuals or groups) without disrupting the market order.

¹¹⁷ In Hayek’s words, “The particular content of the order will depend on the concrete circumstances known only to the individuals who obey the rules and apply them to facts known only to them. It will be through the knowledge of these individuals both of the rules and of the particular facts that both will determine the resulting order” (Hayek 1973, LLL 1, p. 46).

¹¹⁸ Hayek drew again on an analogy from the nature to demonstrate this: “We can never produce a crystal or a complex organic compound by placing the individual atoms in such a position that they will form the lattice of a crystal or the system based on the benzol rings which make up an organic compound. But we can create the conditions in which they will arrange themselves in such a manner” (Hayek 1973, LLL 1, p. 40).

What is most questionable regarding Hayek's differentiation between spontaneous order and organization is his assertion that the comprehensive or overall spontaneous order of society include also organizations.

What we can explain and influence is only the general character of spontaneous orders. The only way of affecting and improving a spontaneous order is that of improving rules (Hayek 1973, LLL 1, p. 45 and p. 51). Thus formation and improvement of a spontaneous order depend on the rules. Arguably, rules are therefore the most important factor in Hayek's theory of spontaneous order and evolution.

Rules and Rule-Following Behavior

There are several questions which must be addressed in this regard.

Firstly, not all rules are conducive to the formation of an overall order.¹¹⁹ Rules 'appropriate' for that are not the product of human reason but that of selective evolution, which I deal with below (Ch. 4).

Secondly, rules must be generally observed if they are to induce the spontaneous formation of an order. For Hayek rules are not subject to rational choice of individuals. The rules are not followed by the individuals because they know and foresee effects of their rule-following behavior (of inducing and maintaining a spontaneous overall order with its benefits). Drawing again on his analogy to nature ('natural' spontaneous orders such as crystal and interaction of iron filings and magnet) Hayek maintained that the rules need not even be known to acting individuals¹²⁰: "it is sufficient that the elements [individuals] actually behave in a manner which can be described by such rules" (Hayek 1973, LLL 1, p. 43). From the regularity of the actions of individuals we can infer that they are *factually* following certain rules (this follows also from his definition of order given above).

¹¹⁹ See Hayek (1973, LLL 1, p. 44): "It is evident that in society some perfectly regular behavior of the individuals could produce only disorder: if the rule were that any individual should try to kill any other he encountered, or flee as soon as other, the result would be clearly be the complete impossibility of an order in which the activities of the individuals were based on collaboration with others".

¹²⁰ For consequence of this aspect for Hayek's theory of evolution see below (Ch. 4: above all Alchian vs. Penrose).

Individuals benefit from a spontaneous overall order of society (which Hayek calls Great Society or in terms of Popper Open Society). But they do not follow the rules because they know the relation between their rule-following behavior and the resulting spontaneous order from which they draw benefits. They follow a system of rules (as a bundle or as a cluster so to speak) and cannot know which parts of rules serve which purposes or functions. But then, why do individuals follow the rules at all? Hayek offered some reasons for that:

“Some such rules all individuals of a society will obey because of the similar manner in which their environment represents itself to their minds. Other they will follow spontaneously because they will be part of their common cultural tradition. But there will be still others which they have to be made to obey, since, although it would be in the interest of each to disregard them, the overall order on which the success of their actions depends will arise only if these rules are generally followed” (Hayek, LLL 1, p. 45).

For Hayek not the reason why and how but the fact *that* the general obedience of rules is established is most important. The most important part of its explanation is offered by his theory of cultural evolution with its group selection which I shall deal with in more detail below. Hayek formulated a main line of reasoning in this respect already in the 1960s which became more explicit in his later work (Hayek 1973, 1979, 1988). :

“The individual may have no idea what this overall order is that results from his observing such rules as those concerning kinship and intermarriage, or the succession to property, or which function this overall order serves. Yet all the individuals of the species which exit will behave in that manner because groups of individuals which have thus behaved have displaced those which did not do so” (Hayek 1967a, SPPE, p. 70).

“Such rules come to be observed because in fact they give the group in which they are practiced superior strength, and not because this effect is known to those who are guided by them. Although such rules come to be generally accepted because their observation produces certain consequences, they are not observed with the intention of producing those consequences – consequences which the acting person need not know” (Hayek 1973, LLL 1, p. 19).

Thirdly, a question arises: if ‘appropriate’ rules are mainly the outcome of evolutionary selection, how can we improve the rules, which is for Hayek the only way of

influencing and improving a spontaneous order without disrupting it. Hayek suggested ‘immanent criticism’ which resembles judicial process according to the common law tradition and which is grounded on ‘rational reconstruction’ as the only way of accomplishing it (see below Ch. 5).

Fourthly, it is about the functions that the rules play in the spontaneous order on the one hand and in his theoretical framework on the other (see below: Hayek and OIE on institutions).

Rules for Market or market for rules (rules of competition or competition of rules)

For Hayek market order is a paradigmatic example of spontaneous orders. Thus market order needs rules and institutions for its functioning. Explicit recognition of institutional and legal framework for market economy is a characteristic which distinguishes his theory from conventional neoclassical economics. According to Hayek this fact was recognized and emphasized by classical economists, especially by Scottish moral philosophers such as David Hume, Adam Smith and Adam Ferguson. A common interpretation that their theories embody the doctrine or principle of *laissez-faire* is due to misunderstanding of their successors which harmed the case for liberalism.¹²¹ For Hayek liberalism does not amount to ‘*laissez-faire*’:

“The liberal argument is in favor of making the best possible use of the forces of competition as a means of coordinating human efforts, not an argument for leaving things just as they are. It is based on the conviction that, where effective competition can be created, it is a better way of guiding individual efforts than any other. It does not deny, but even emphasizes, that, in order that competition should work beneficially, *a carefully thought-out legal framework* is required and that neither the existing nor the past legal rule are free from grave defects. Nor does it deny that, where it is impossi-

¹²¹ Cf. Hayek /1944/1994, p. 21): “There is nothing in the basic principles of liberalism to make it a stationary creed; there are no hard-and-fast rules fixed once and for all. 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. Probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rule of thumb, above all the principle of *laissez faire*.”

ble to create the conditions necessary to make competition effective, we must resort to other methods of guiding economic activity” (Hayek 1944/1994, p. 41; emphasis added).

In a similar vein Hayek argued further:

“In no system that could be rationally defended would the state just do nothing. An effective competitive system needs an *intelligently designed and continuously adjusted legal framework* as much as any other. Even the most essential prerequisite of its proper functioning, the prevention of fraud and deception (including exploitation of ignorance), provides a great and by no means yet fully accomplished object of legislative activity” (Hayek 1944/1994, p. 45; emphasis added).¹²²

Hayek also denied that classical liberal economists and philosophers (above all Adam Smith) assumed that “there existed a “natural harmony of interests” irrespective of the positive institutions” (Hayek 1945a, p. 13). Neither did they hold such “naïve views” as “natural goodness of man” or the beneficent effects of “natural liberty” (though they did sometimes use the last notion but never meant it literally): “They knew that it required the artifices of institutions and traditions to reconcile the conflicts of interest” (Hayek 1960, CL, p. 60).

On this line of interpretation of English (or Scottish) classical economists Hayek’s view is in accord with ‘revisionist’ view put forward by Lionel Robbins (1952) and on the whole also by Warren Samuels (1966). Interpretations of Adam Smith to the similar effect were firstly suggested by Viner (1927) and followed by Rosenberg (1960) and by Winch (1979 and 1997).

In a seminal paper Viner stated that “Adam Smith was not a doctrinaire advocate of *laissez faire*.” (Viner 1927, p. 231) and argued further:

“Smith saw that self-interest and competition were sometimes treacherous to the public interest they were supposed to serve, and he was prepared to have government exercise some measure of control

¹²² Cf. Hayek (1944/1994, p. 43): “The functioning of a competition not only requires adequate organization of certain institutions like money, markets, and channels of information – some of which can never be adequately provided by private enterprise – but it depends, above all, on the existence of an appropriate legal system, a legal system designed both to preserve competition and to make it operate as beneficially as possible. It is by no means sufficient that the law should recognize the principle of private property and freedom of contract; much depends on the precise definition of the right of property as applied to different things. The systematic study of the forms of legal institutions which will make the competitive system work efficiently has been sadly neglected.”

over them where the need could be shown and the competence of government for the task demonstrated” (Viner 1927, p. 232).¹²³

In a similar vein Rosenberg (1960, p. 567) pointed out that Adam Smith is searching in *Wealth of Nations* for “an institutional scheme which will establish and enforce an identity of interests between the public and private spheres”:

“A neglected theme running through virtually all of the *Wealth of Nations* is Smith’s attempt to define, in very specific terms, the details of the institutional structure which will best harmonize the individual’s pursuit of his selfish interests with the broader interests with the broader interests of society. Far from assuming a “spontaneous” identity of interests (in the mere absence of government restrictions) or of being “blind to social conflicts,” Smith was obsessed with the urge to go beyond the ordinary market-structure definition of competition and to evaluate the effectiveness of different institutional forms in *enforcing* this identity.” (Rosenberg 1960, p. 559)

For Rosenberg it is from this perspective that Adam Smith’s critique of the mercantile system and his endorsement of the price system must be assessed.¹²⁴

Though Hayek’s interpretations of classical economists may be in agreement with the ‘revisionist’ interpretations (that classical economists did neither represent laissez-faire doctrine¹²⁵ nor assume the existence of natural harmony between individual (or sectional) interests and public interests and that they recognized the necessity of institutional framework for the reconciliation of different interests and for proper working of market economy), Hayek’s main concern was to demonstrate that those rules and institutions are mainly of spontaneous growth (“result of human action and not of human design”¹²⁶) beyond deliberate design and control, and to further refine

¹²³ According to Viner, Adam Smith’s reservation against government activities is not matter of principle, but a reflection of incapability of the English government of his day (cf. Viner (1927, p. 221f.); see also Rosenberg (1960, p. 565f.). Therefore, “The modern advocate of laissez faire who objects to government participation in business on the ground that it is an encroachment upon a field reserved by nature for private enterprise cannot find support for this argument in the *Wealth of Nations*.” (Viner 1927, p. 227)

¹²⁴ See Rosenberg (1960, p. 560): “The price system, as Smith saw it, was an intensely coercive mechanism. Its decisive superiority as a way of organizing economic life lay in the fact that, *when it was surrounded by the appropriate institutions*, it tied the dynamic and powerful motive force of self-interest to the general welfare.”

¹²⁵ Compare Handlin (1943); Sorenson (1952); Kittrell (1966).

¹²⁶ See Hayek (1945a, pp. 6f.; 1960, pp. 57f; 1967b; 1973, pp. 20f.).

this insight or discovery of Scottish philosophers with his theory of spontaneous order and of cultural evolution.

“It was not ‘natural liberty’ in any literal sense, but the institutions *evolved* to secure “life, liberty, and property,” which made those individual efforts beneficial. ... Their argument was never a complete laissez faire argument, which ... was never defended by any of the English classical economists. They knew better than most of their later critics that it was not some sort of magic but the *evolution of “well-constructed institutions,”*¹²⁷ where the “rules and principles of contending interests and compromised advantages” would be reconciled, that had successfully channeled individual efforts to socially beneficial aims” (Hayek 1960, CL, p. 60; emphasis added).

It must be questioned, however, what kind of substantial differences there may exist between ‘natural harmony of interests’ on the one hand and spontaneous-evolutionary growth of rules and institutions which bring about harmony of interests on the other. Furthermore, if, as Hayek suggested, institutional frameworks for market (by which Hayek mostly meant rules of property rights and contracts) are themselves mainly the outcome of evolutionary selection, it is a kind of a closed system or of a ‘natural’ process which requires no interference or ‘correction’.¹²⁸ This seems to be the essence of Hayek’s understanding of market economy as a spontaneous order which is for Hayek analogous to self-organizing or self-generating systems in cybernetics.

In 1944 Hayek spoke of “gradual improvement of the institutional framework of a free society” (Hayek 1944/1994, p. 22) and of “positive requirements of a successful working of the competitive system” (ibid, p. 43); in 1945 of “the fascinating subject of a suitable legal framework for an effective individualist system” (1945a, p. 21). Hayek (1960) was still concerned with “positive task of improving our institutions” (p. 5) or with “to improve human institutions so as to increase the chances of correct foresight” (p. 30). With increasing importance of his evolutionary argument especially in his later work (Hayek 1973, 1979, 1988), it has become more difficult to

¹²⁷ It may not be quite meticulous to ask how *well-constructed* institutions *evolve* and what this exactly means.

¹²⁸ As Boehm (1989, p. 211) asked, “if markets crucially depend on traditional institutions for their operation, how can they themselves be such a traditional institution?”

find a ‘balance act’ of reconciling *positive* task or *positive* requirements with a “*naturalistic* evolutionary process”¹²⁹ (Hayek 1988, FC, p. 74; emphasis added).

Though I shall deal with Hayek’s theory of evolution in more detail below, a quotation may be in place to show what his evolutionism amounts to in this regard:

“It were favorable moral traditions which made particular groups strong rather than intellectual design that made the progress of the past possible and will do so also in the future. To confine evolution to what we can foresee would be to stop progress; and it is due to the favorable framework which is provided by a free market ... that the new which is better has a chance to emerge” (Hayek 1979, LLL 3, p. 169).

This is not to say that this kind of tension, if not contradiction, is to be found only in his later work. It is rather characteristic of Hayek’s whole work, which, according to Kukathas (1989, pp. 210-1), stems from Hayek’s drawing on two different liberal philosophies of Hume and Kant:

“Like Hume, Hayek has argued, on the basis of his anti-constructivist viewpoint, that reason can only guide us by indicating what courses of action are *not* open to us but cannot supply us with justifications for right action. Reason’s limited powers means that we cannot construct our ideal social institutions or guide their evolution in preferred directions. Yet, on the other hand, Hayek, quite unlike Hume, is not content to allow evolution to take its course, or even to disavow any adherence to the principles which must underlie the laws of the good society.”

This line of reasoning of Hayek leads to a kind of circular argument that rules and institutions for competition must be found or discovered by selective evolutionary process which is in substance equivalent to (market) competition.¹³⁰ It must be questioned, then, what role there still remains for “intelligent design”.¹³¹ In a sense, this dilemma or conundrum is revealed by his formulation of “*evolution of well-*

¹²⁹ To my knowledge, this is one of few occasions where Hayek explicitly related the term ‘naturalistic’ to his theory of (otherwise ‘social’ or ‘cultural’) evolution. With this Hayek might have revealed unwittingly the real nature of his evolutionism, with which I shall deal below (Ch. 4).

¹³⁰ Hayek (1988, FC, p. 19): “Competition is a procedure of discovery, a procedure involved in all evolution, that led man unwittingly to respond to novel situations.”; Hayek (ibid, p. 26): “Not only all evolution rest on competition; continuing competition is necessary even to preserve existing achievements.” See also Hayek (1960, CL, pp. 36f.).

¹³¹ Though it concerns two levels of competition, its solution cannot avoid infinite regress, to which, I would argue, Vanberg’s attempt at reconciliation is susceptible (see Vanberg 1994a, 1994b).

constructed institutions” (Hayek 1960, CL, p. 60; see above). I shall demonstrate below (Ch. 5) that Hayek’s suggestion of ‘immanent criticism’ based on ‘rational reconstruction’ as a (for him the only) way of resolving this conflict does not fulfill the task.

Hayek and OIE on rules and institutions

Hayek’s view on rules is very similar to that of OIE. It may be that an alternative to mainstream economics which is based on rational choice on every occasion can best be grounded on different behavioral assumption of some regularity and stability following from habits, customs, conventions etc, that is, institutions in broader term put forward foremost by Veblen. Hayek put it:

“In the pursuit of our individual aims, we are not likely to be successful unless we lay down for ourselves some general rules to which we will adhere without reexamining their justification in every particular instance. In ordering our day ... we frequently find it necessary to make such practices an unconscious habit, because we know that without this the rational grounds which make such behavior desirable would not be sufficiently effective to balance temporary desires and to make us do what we should wish to do from a long-term point of view. ... in order to make ourselves act rationally we often find it necessary to be guided by habit rather than reflection, ... to prevent ourselves from making the wrong decision we must deliberately reduce the range of choice before us ...” (Hayek 1960, CL, p. 66).

This fits in with Hayek’s critique of constructivist rationalism (which sometimes borders on agnosticism due to ignorance or non-knowledge of acting individuals as to why they do what they do; nonetheless their interactions spontaneously form a social order which is beneficial for its members) and with his brand of evolutionary rationalism (see below).

For Hayek “Man is as much a *rule-following animal* as a purpose-seeking one (Hayek 1973, LLL 1, p. 11; emphasis added). Hayek found in the rules and rule-following behavior as foundations for spontaneous orders an analytical tool which can establish his third realm beyond the natural and the artificial and which can be used as a weapon against constructivist rationalism. Customs and traditions based on learned rules stand between instinct and reason, whether his third realm lies. Obser-

vance of learned rules as standing between innate (genetically transmitted) rules and rational design leads to spontaneous orders with its benefits of utilization of knowledge and experiences of generations embodied in them without other ordering principles of inherent human nature or of deliberate design by human rationality or other superhuman intelligence.

Thus it is not surprising to observe that there are some important similarities between Hayek and Old Institutionalists regarding rules and institutions: both are directed against maximizing rationality of neoclassical theory. Hayek was concerned about wider implications of conceiving reason and rationality represented by neoclassical economics: that everything can be made subject to choice by this kind of rationality, judged and acted thereupon; that everything can be changed and invented as if starting from scratch. In this way spontaneous orders can be destroyed and with them customs and traditions which are indispensable for civilization, but which themselves cannot be explained and justified by rationalistic arguments.

Hayekian knowledge includes “all the human adaptations to environments in which past experience has been incorporated”, more than scientific, explicit or conscious knowledge:

“Our habits and skills, our emotional attitudes, our tools, and our institutions – all are in this sense adaptations to past experience which have grown up by selective elimination of less suitable conduct. They are as much an indispensable foundation of successful action as is our conscious knowledge” (Hayek 1960, p. 25-6).

And this extension of the notion of knowledge reinforces his overall argument, because it shows more clearly that the kind of knowledge which is relevant for the growth of civilization is more wider than that which can be possessed by any individuals or groups, still less be centralized in any kind of planning agency.¹³² Fur-

¹³²Cf. Hayek (1952/1979, pp. 149-50): “Though our civilization is the result of a cumulation of individual knowledge, it is not by the explicit or conscious combination of all this knowledge in any individual brain, but by its embodiment in symbols which we use without understanding them, in habits and institutions, tools and concepts, that man in society is constantly able to profit from body of knowledge neither he nor any other man completely possesses. Many of the greatest things man has achieved are the result not of consciously directed thought, and still less the product of a deliberately

thermore it enables Hayek readily to incorporate his knowledge argument into his theory of evolution on the one hand and to more firmly ground his anti-rationalist argument on a kind of institutionalist or path-dependency argument.¹³³

It invokes (old) institutionalist arguments insofar as it embraces non-rational (unconscious) factors in explaining institutions and individual behavior not resulting from (conscious, maximizing) rationality but as a rule-following behavior.¹³⁴ As a result of growth of knowledge, “the limitations of his conscious knowledge and therefore the range of ignorance significant for his conscious action have constantly increased”; “The very division of knowledge increases the necessary ignorance of the individual of most of this knowledge” (Hayek 1960, p. 26).¹³⁵ Hayek epitomized unconscious part of knowledge (compared to conscious, explicit, scientific knowledge) as “tools” in the widest sense which human beings have evolved and which enable them to deal with their environment. “They consist in a large measure of forms of conduct which he habitually follows without knowing why; they consist of what we call “traditions” and “institutions,” which he uses because they are available to him as a product of cumulative growth without ever having been designed by any one mind”; They are “the results of the experience of successive generations which are handed down”; They are “*tested and generally adopted ways of doing things*” (Hayek 1960, p. 27; italics added). And this reveals a striking resemblance with the Veblen’s definition of institutions as “settled habits of thought common to the gener-

coordinated effort of many individuals, but of a process in which the individual plays a part which he can never fully understand. They are greater than any individual precisely because they result from the combination of knowledge more extensive than a single mind can master.”

¹³³ Cf. David (1994, p. 215): “Historical precedent thus can become important in the shaping of the whole institutional cluster, simply because each new component that is added must be adapted to interlock with elements of the pre-existing structure – *unless the whole is to be abandoned and replaced in its entirety.*”

¹³⁴ Cf. Kukathas (1989, p. 90): “At the heart of Hayek’s social theory ... lies not a view of *homo economicus* but of man as a rule-following behavior.”

¹³⁵ A similar argument was suggested by Heiner (1983, p. 580): “At some point, the evolution of more complex social interdependence will stop, unless social structures also evolve that reduce the scope of nonlocal information that individual agents must know to reliably forecast the consequences of their own behavior. (In more precise terms, the scope of information over which agents can reliably interpret successively narrows as the social environment becomes more complex.) In general, further evolution toward social interdependence will require institutions that permit agents to know about successively smaller fractions of the larger social environment. That is, *institutions must evolve which enable each agent in the society to know less and less about the behavior of other agents and about the complex interdependencies generated by their interaction.*”

ality of men” (Veblen 1909, p. 239) or as an “outgrowth of habit” (ibid, p. 241).¹³⁶

Veblen’s critique of “marginal-utility school” in this regard is roughly the same with Hayek’s critique of neoclassical theory¹³⁷: The school conceives and interprets human conduct as “a rational response to the exigencies of the situation in which mankind is placed”; It takes account of conduct “only in so far as it is rational conduct, guided by deliberate and exhaustively intelligent choice” (ibid, p. 234f.).

With the notion of learned rules which, according to Hayek, are (or rather ought to be) abstract, general and negative, Hayek tried to criticize neoclassical theory; to establish the third realm; and to minimize relevance of deliberate change while relying on spontaneous change. OIE shares with Hayek the first aim, but not the latter two. As I shall argue below¹³⁸, for critical assessment of Hayek’s theory it is important to come to terms with institutionalist affinity of some aspects of Hayek’s theory.

Hayek’s recourse to “non-rational factors underlying human action”, “unconscious habit” and to ‘unconscious’ (implicit) knowledge represents his attempt to substantiating (and ‘promoting’) general rule-following behaviour and function of rules which cannot be rationally or consciously justified, but nonetheless on which emergence and growth of human civilization decisively depends. Hayek even identified growth of civilization with growth of knowledge as far as “we interpret knowledge to include all the human adaptations to environment in which past experience has been incorporated” (Hayek 1960, CL, p. 26). Hayek repeatedly drew the contrast between ‘knowing how’ and ‘know that’, which implies that the former category is a suffi-

¹³⁶ Veblen (1909, pp. 241-2) writes further: “The growth of culture is a cumulative sequence of habituation, and the ways and means of it are the habitual response of human nature to exigencies that vary incontinently[0], cumulatively, but with something of a consistent sequence in the cumulative variations that so go forward, - incontinently, because each new move creates a new situation which induces a further new variation in the habitual manner of response; cumulatively, because each new situation is a variation of what has gone before it and embodies as causal factors all that has been effected by what went before; consistently, because the underlying traits of human nature (propensities, aptitudes, and what not) by force of which the response takes place, and on the ground of which the habituation takes effect, remain substantially unchanged.”

¹³⁷ This is not surprising when we take into account Jaffé’s ‘de-homogenization’ of three founding fathers of the marginal revolution. Jaffé (1976, p. 518 and p. 521) argues that “Carl Menger clearly stands apart from the other two reputed founders of the modern marginal utility theory. ... Thorstein Veblen’s strictures upon what he considered the Austrian preconception of human nature fits Jevons’s or Walras’s theory much better than they do Menger’s.”

¹³⁸ See Ch. 4, *evolution and rule-following behavior*.

cient foundation for rule-following behaviour¹³⁹: this is also shown by Hayek's distinction between "knowledge of cause and effect" and "knowledge of rules of conduct" (Hayek 1973, LLL 1, p. 80).

In the wider term of knowledge Hayek used it is substantially equivalent to rules

"under which the citizens act constitute an adaptation of the whole of society to its environment and to the general characteristics of its members. They serve, or should serve, to assist the individuals in forming plans of action that they will have a good chance of carrying through" (Hayek 1960, CL, p. 157).

Thus rules which embody a coherent totality of social adaptations are for Hayek "a device for coping with our constitutional ignorance" (Hayek 1976, LLL 2, p. 8). They function as "a means for overcoming the obstacle presented by our ignorance of the particular facts which must determine the overall order" (ibid.). Thus rule-following behavior or "the reliance on abstract rules" is "a device we have learned to use because our reason is insufficient to master the full detail of complex reality" (Hayek 1960, CL, p. 66).

Hayek's argument that orders arise spontaneously by individuals observing rules while pursuing their own ends and using their several knowledge is consequent upon his suggestion of rules as embodiment of whole human adaptations to particular circumstances which (almost by definition) nobody can master alone. Thus the function which the rules serve in society is essentially the same with the function which the price system performs in the economic sphere. That the rules can perform that function is to be explained by his theory of evolution. As I argued above (Ch. 1), Hayek had no theory on or explanation of formation of prices (at least which is substantially different from neoclassical theory), but merely explanation of the functions or roles which the price system performs in a competitive market economy. Neither did he state explicitly whether the prices must be equilibrium prices or not in order to perform those functions: if they are to be disequilibrium prices he must have explained how economy can be coordinated by disequilibrium prices; if they are equi-

¹³⁹ Cf. Hayek (1973, LLL 1, p. 99): "So long as the individuals act in accordance with the rules it is not necessary that they be consciously aware of the rules. It is enough that they know how to act in accordance with the rules without knowing that the rules are such and such in an articulated terms."

librium prices, it contradicts all his critique of neoclassical notion of equilibrium. A suggestion for resolution can be found in his interpretation of market as working on the “cybernetic principle of negative feedback” (Hayek 1976, LLL 2, p. 94). Another suggestion might be called ‘evolutionary theory of price formation’¹⁴⁰ which explains prices (or price system) form itself analogous to the process of spontaneous formation and evolution. Hayek might have implied this when he argued (Hayek 1988, FC, pp. 86-7):

“The order of the extended economy is, and can be, formed only by a wholly different process – from an *evolved method of communication* that makes it possible to transmit, not an infinite multiplicity of reports about particular facts, but merely certain abstract properties of several particular conditions such as competitive prices, which must be brought into mutual correspondence to achieve overall order. These communicate the different rates of substitution or equivalence that the several parties involved find prevailing between the various goods and services whose use they command. ... Surprising as it may be that such a process exists at all, let alone that it came into being through *evolutionary selection* without being deliberately designed, I know of no efforts to refute this contention or discredit the process itself – unless one so regards simple declarations that all such facts can, somehow, be known to some central planning authority.”¹⁴¹

A third related suggestion might be that prices alone cannot coordinate all economic activities and serve utilization of all available knowledge but they must be supported by rules and institutions.

Constructivist Rationalism vs. Evolutionary Rationalism

One of Hayek’s main concerns is that the existence of spontaneous orders and the understanding of their properties and benefits are obscured and denied, even distorted by what Hayek called constructivist rationalism, “a conception which assumes that all social institutions are, and ought to be, the product of deliberate design”. To criticize this, in Hayek’s view, erroneous conception of the formation of social institutions is important because it is the chief source of many mistaken, though widely

¹⁴⁰ This might suggest that Hayek explained the formation of *price system* (concomitant with market order) by his theory of spontaneous order and cultural evolution, which he adumbrated already in 1945 (Hayek 1945b, p. 88). But on the other hand he explained the formation of *prices* by neoclassical marginal utility theory as he did in Hayek (1988, p. 97 and p. 148).

¹⁴¹ In the last sentence allusion to the Socialist Calculation Debate (SCD) is unmistakable.

held, views on the social process and policy in general. His twin ideas serve the aim of demonstrating that:

“[Constructivist rationalism is] false both in its factual and in its normative conclusions, because the existing institutions are not all the product of design, neither would it be possible to make the social order wholly dependent on design without at the same time greatly restricting the utilization of available knowledge” (Hayek 1973, LLL 1, p. 5).¹⁴²

Indeed all erroneous scientific, philosophical and political views with fatal consequences (such as legal positivism, utilitarianism, socialism and totalitarianism) are “child of constructivism” (ibid, p. 6). This ‘false rationalism’ lead to the fatal consequence of destroying values which are indispensable foundation of civilization,¹⁴³ whereas ‘right rationalism’ which Hayek called “evolutionary rationalism” (or “critical rationalism” referring to Karl Popper) recognizes “the states of values as independent and guiding conditions of all rational construction” (ibid, p. 6).¹⁴⁴ His twin ideas can be seen as an attempt, on the one hand, at criticizing constructivist rationalism since other erroneous conceptions (above all, of course, socialism) “stand or fall” with it, and, on the other hand, at substantiating evolutionary rationalism and establishing it as the only ‘legitimate’ or ‘true’ basis for social theory and policy. Hayek repeatedly argued that the differences between socialists and no-socialists ultimately rest on “purely intellectual issues capable of a scientific resolution and not on different judgments of values” (ibid, p. 6; cf. Hayek 1988, FC, p. 7).

¹⁴² As I shall show shortly below, Hayek made a maximum demand on the constructivist rationalism whereas on the ‘evolutionary rationalism’ not. This tendency in Hayek’s approach, though in other context, is already pointed out by Viner (1961, p. 230): “To attack an extreme position when it is not clear that a more moderate position is open to the same *kind* of objections may be, depending on the historical context, to attack a straw man”.

¹⁴³ Cf. Hayek (1973, LLL 1, p. 7): “The tendency of constructivism to represent those values which it cannot explain as determined by arbitrary human decisions, or acts of will, or mere emotions, rather than as the necessary conditions of facts which are taken for granted by its expounders, has done much to shake the foundations of civilization, and of science itself, which also rests on a system of values which cannot be scientifically proved.”

¹⁴⁴ Similar line of dichotomous classification between right or true ideas or thoughts on the one hand and wrong or false ones on the other was made throughout his entire work (cf. Hayek 1945a; Hayek 1960, CL, pp. 54ff; Hayek 1973, LLL 1, pp. 20ff; Hayek 1988, FC, pp. 48ff.): Already in 1945 Hayek stated, “this contrast between the true, antirationalistic and the false, rationalistic individualism permeates all social thought” (Hayek 1945a, p. 11). Later Hayek replaced the term ‘anti-rationalism’ by ‘evolutionary rationalism’.

As I shall try to demonstrate below,¹⁴⁵ Hayek's twin ideas are themselves grounded on normative arguments that evolutionary rationalism *ought to* be followed for understanding and thereby improving economy and society and constructivism be abandoned, which must not necessarily be accepted by everyone. Hayek's evolutionary rationalism requires that evolution be guided by (right) ideas or principles underlying his theories of spontaneous order and cultural evolution. The main content of these theories is, however, that a beneficial social order can arise in a spontaneous-evolutionary manner, which is thus not compatible with any guidance. That a theory of evolution which explains the process of evolution can and must also guide it means supposing that there is a desirable course of evolution which is predetermined by a theory which explains superiority of evolution over design, which Hayek in this formulation would reject (cf. Hayek 1973, LLL 1, pp. 23f.), but his theory in the end amounts to.¹⁴⁶ As I shall show below (Ch. 4), for Hayek there is no absolute standard for (rightness or appropriateness of) rules and morals: They can be assessed only on their ex-post conduciveness to viability of an order. Thus Hayek has no basis for asserting that his theory of evolution is the only right way of understanding evolution. So long as he did not offer a theory of evolution of ideas which must guide the real process of evolution, there must be an infinite regress which cannot simply be assumed to end with his theory of evolution.¹⁴⁷

Though Hayek spoke of the "great struggle of ideas" which we must win (Hayek 1960, CL, p. 2), he nonetheless asserted that

"it is, of course, a mistake to believe that we can draw conclusions about what our values ought to be simply because we realize that they are a product of evolution. ... All that we can know is that the

¹⁴⁵ See Ch. 5, above all, *Evolution of Ideas or Ideas of Evolution*.

¹⁴⁶ In a somewhat similar vein Vanberg (1994b, p. 179) points to a "fundamental tension" between "rational liberalism" and "evolutionary agnosticism" contained in Hayek's work: "By rational liberalism I mean the message implied in those parts of Hayek's arguments that spell out reasons why such an order can be considered preferable to alternative arrangements, and what can be done to establish and maintain it. By contrast, evolutionary agnosticism refers to a certain tenor in Hayek's thoughts on cultural evolution that seems to suggest that any efforts in deliberate institutional reform and construction must ultimately be futile in the face of an evolutionary process that pays no attention to what we may consider to be desirable or beneficial".

¹⁴⁷ What is confusing in Hayek's theory of spontaneous order and evolution is that there are frequent (and 'unnoticed') changes between the explanation of ex-ante criterion and justification of ex-post outcome; and between the perspective of the observer and that of acting individuals.

ultimate decision about what is good and bad will be made not by individual human wisdom but by the decline of the groups that have adhered to the “wrong” beliefs” (Hayek 1960, CL, p. 36).¹⁴⁸

Functioning Mechanism of Market Order: Negative Feedback (Price Signals as Rules)

The market order (for which Hayek coined the term *catallaxy* to distinguish it from “economy proper” which has a single scale or hierarchy of ends such as a household, a farm or an enterprise and which is thus an organization according to Hayek’s classification) is “the special kind of spontaneous order though people acting within the rules of the law of property, tort and contract” (Hayek 1976, LLL 2, p. 109).

Hayek made several assertions regarding the features of the market order, its functioning mechanism and the nature of the benefits we owe to it. Like all order it serves our ends by bringing out a certain correspondence between the expectations of different individuals. It makes the (economic) chances of anyone selected at random as great as possible or increases “the prospects or chances of every one of a greater command over the various goods (i.e. commodities and services)” (Hayek 1976, LLL 2, p. 107). While coordination of individual actions by market order secures “a high degree of coincidence of expectations and an effective utilization of the knowledge and skills of the several members”, this is possible “only at the price of a constant disappointment of some expectations” (ibid, p. 107).¹⁴⁹

Dispersed knowledge can be most effectively utilized by the activities and efforts of the individuals being constantly adjusted to a greater variety of facts than can be

¹⁴⁸ Hayek argued similarly in Hayek (1960, CL, p. 67; italics added): “Just as a group may owe its rise to the morals which its members obey, and their values in consequence be ultimately imitated by the whole nation which the successful group has come to lead, so may a group or nation destroy itself by the moral beliefs to which it adheres. *Only the eventual results can show* whether the ideals which guide a group are beneficial or destructive.” This assertion cannot be falsified for it is circular, just as the thesis of ‘survival of the fittest’ can be circular; if fitness cannot be defined ex-ante and independent of the survival, this contends only that what has survived must be by definition the fittest. Impossibility of falsification is not a minor critique for Hayek, follower of Popper’s philosophy of science.

¹⁴⁹ Cf. Hayek (1968, p. 185): “The fact that a high degree of coincidence of expectations is of crucial importance for an understanding of the functioning of the market order.”; Hayek (1973, LLL 1, p. 63): “The necessity of adaptation to unforeseen events will always mean that someone is going to be hurt, that someone’s expectations will be disappointed or his efforts frustrated.”

known to any single individual or agency.¹⁵⁰ This can be achieved by a market order which as a spontaneous order serves no single scale or hierarchy of ends as an organization (“economy proper”) does, but serves “the multiplicity of separate and incommensurable ends of all its separate members” (ibid., p. 108) only as far as a viable degree of mutual correspondence of expectations or mutual adjustment of individual plans is secured. This is provided by price mechanism in the market order which works in accordance with the “cybernetic principle of negative feedback” (ibid, p. 94). Hayek put it:

“The correspondence of expectations that makes it possible for all parties to achieve what they are striving for is in fact brought about by a process of learning by trial and error which must involve a constant disappointment of some expectations. The process of adaptation operates, as do the adjustments of any self-organizing system, by what cybernetics has taught us to call negative feedback: responses to the differences between the expected and the actual results of actions so that these differences will be reduced” (ibid, pp. 124-5).

“The abstract rule of conduct can (and, in order to secure the formation of a spontaneous order, should) thus protect only the expectation of command over particular physical things and services, and not the expectations concerning their market value, i.e. the terms on which they can be exchanged for other things. ... It can, therefore, not assure any one that goods and services which he has to offer will have a particular value, but only that he will be allowed to obtain for them what price they can” (Hayek LLL 2, p. 124).

Thus “we can make effective use of that dispersed knowledge only if ... we allow the principle of negative feedback to operate, which means that some must suffer unmerited disappointment” (ibid., p. 71). Hayek in this regard subscribed to Hardin’s interpretation which compares Adam Smith’s invisible hand to negative feedback and suggests Smith as the originator of cybernetics. Hayek’s repeated reference to Hardin¹⁵¹ makes it worthwhile to cite him in some length:

¹⁵⁰ In Hayek’s context, utilization of dispersed knowledge on the one hand and constant adaptation of the society as a whole to particular circumstances and facts which are not known to anybody in totality on the other actually point to the same process.

¹⁵¹ Cf. Hayek 1967c, p. 74, n. 5; Hayek 1968, p. 184; Hayek 1973, p. 156, n. 7; Hayek 1976, p. 178, n. 11; Hayek 1988, p. 146)

“Long before Claude Bernard, Clerk Maxwell, Walter B. Cannon, or Norbert Wiener developed cybernetics, Adam Smith has just as clearly used the idea in *The Wealth of Nations*. The “invisible hand” that regulated prices to a nicety is clearly this idea. In a free market, says Smith in effect, prices are regulated by negative feedback.”¹⁵²

Basing on this insight Hayek argues:

“The much ridiculed ‘miracle’ that the pursuit of self-interest serves the general interest reduces to the *self-evident proposition* that an order in which the action of the elements is to be guided by effects of which they cannot know can be achieved only if they are reduced to respond to signals reflecting the effects of those events. What was familiar to Adam Smith has belatedly been rediscovered by scientific fashion under the name of ‘self-organizing systems’” (Hayek 1976, LLL 2, p. 178, n. 11; emphasis added).

4. Hayek’s theory of cultural evolution

The primary ‘role’ of Hayekian evolution¹⁵³ is to ‘produce’ appropriate rules, via a selection process, which serve the formation of spontaneous orders. This role is fundamental, for, whereas factual observance of rules leads to formation of spontaneous orders, not all rules accomplish this ‘task’:

“Not every regularity in the behavior of the elements does secure an overall order. Some rules governing individual behavior might clearly make altogether impossible the formation of an overall order” (Hayek 1973, LLL 1, p. 44).¹⁵⁴

“Society can thus exist only if by a process of selection rules have evolved which lead individuals to behave in a manner which makes social life possible” (Hayek 1973, LLL 1, p. 44).

¹⁵² Cf. Garret J. Hardin (1961), *Nature and Man’s Fate*, New York, p. 55. Cited from Hayek (1968, p. 184).

¹⁵³ Caldwell (2000, p. 5) summarizes critiques put forward against Hayek’s theory of cultural evolution as follows: (1): “His analysis of the evolutionary process is too pessimistic, leaving little room for attempts to improve the institutional or constitutional setting”; (2): “Hayek’s endorsement of group selection as the mechanism by which cultural institutions are selected is inconsistent with his methodological individualism”; (3): “Group selection itself has been discredited among biologists on grounds that are germane to its applications in the social sciences.” In our context the first critique and to a lesser degree the second one are most important.

¹⁵⁴ Cf. Hayek (1973, LLL 1, p. 44): “[I]n society some perfectly regular behavior of the individuals could produce disorder: if the rule were that any individual should try to kill any other he encountered, or flee as soon as he saw another, the result would clearly be the complete impossibility of an order in which the activities of the individuals were based on collaboration with others.”

Hayek laid down in his *Notes on the Evolution of Systems of Rules of Conduct* (Hayek 1967a) an important theoretical basis for his theory of spontaneous order and cultural evolution. What is most important in this essay is Hayek's emphasis on the necessity of distinguishing between the order of actions of the group and the rules of conduct of the individuals. This paved him the way to deal systematically with evolution of rules and its relation with spontaneous orders.

Hayek's theory of evolution is arguably his most comprehensive assault on the constructivist rationalism and culmination of his knowledge argument and of constructing liberal theory. While the question remains open as to the genesis of Hayek's ideas on cultural evolution,¹⁵⁵ a more important problem to be dealt with is what role his theory of evolution plays in his work. It is a standard for distinguishing 'good' from 'bad' ideas for Hayek¹⁵⁶, whereas ironically evolution in Hayekian scheme does not take the role of selecting 'good' ideas (as I demonstrated above).

In every dichotomous taxonomy of major conceptions (individualism, liberalism, rationalism)¹⁵⁷ the notion of evolution is a dividing characteristic of 'good' or 'true' ideas. The main role of the notion of evolution is to oppose theories based on reason or rationality (unlimited or 'presumptuous' in Hayek's word) and to construct a theory based on non-rationalism. Hayek's paradigm can even be described as evolution (and spontaneous growth) versus reason (and deliberate design). Hayek may have adopted this strategy because he thought that ideas and theories based on rationality cannot serve to constitute theory and policy for liberal economy and society. That is, he may have thought that liberty, defined as a state free from arbitrary coercion,¹⁵⁸

¹⁵⁵ Cf. Caldwell (2000); Caldwell (2004, p. 301) and Hodgson (1993b, pp. 158ff.); Hodgson (2004, pp. 291-2).

¹⁵⁶ In the sense that ideas which correspond to his concept of evolution are 'good' and 'true'.

¹⁵⁷ Cf. Hayek 1945a; Hayek 1960, CL, pp. 54ff; Hayek 1973, LLL 1, pp. 20ff; Hayek 1973/1978, p. 119ff; Hayek 1988, FC, pp. 48ff.

¹⁵⁸ Hayek (especially 1960, CL, pp. 11-21) took pains to clarify the notion of liberty or freedom (which he used interchangeably) and to distinguish his conception of liberty from others. In accordance with his typical dichotomous reasoning Hayek's attempt in this regard is directed at demonstrating that some conceptions of liberty ('liberty as power' or 'liberty as wealth') rather undermine liberty, that only the negative concept of liberty (in the sense of freedom from arbitrary coercion of the state) can safeguard individual liberty. This is rather in contrast to Berlin (1958) who assesses both merits and shortcomings of the negative and positive concept of liberty. Furthermore, it must be noted that whereas Berlin's positive concept means political participation, Hayek not only was skeptical of democracy but also objected to the positive liberty which requires wealth and welfare. Thus seen almost by definition positive liberty (demanding 'social justice' or income redistribution, which I shall deal

can best be safeguarded in a society which can be explained theoretically by the notion of evolution and spontaneous order. Like his knowledge argument origin and reason of this strategy must be sought in Hayek's participation in the socialist calculation debate (SCD), that is, in his critique of neoclassical economics and theory of market socialism based on it. Thus Hayek's transformation has more consequences than is demonstrated by Caldwell. Caldwell (1988) may explain Hayek's shift from narrow technical economics to wide range of disciplines, but he does not deal with its consequence for further development of Hayek's liberalism in terms of theory and policy. We can see this in Hayek's repeated assertion of his self-concept as an economist. That is, he probably thought that liberal economics cannot be constituted from (technical and neoclassical) economics only.

His repeated critique of neoclassical notion of perfect knowledge and of perfect competition can more clearly be understood in this background.

Hayek attempted to elaborate evolutionary concept, which dispenses with rationality concept:

“[T]hat orderliness of society which greatly increased the effectiveness of individual action was not due solely to institutions and practices which had been invented or designed for that purpose, but was largely due to a process described at first as ‘growth’ and later as ‘evolution’, a process in which practices which had first been adopted for other reasons, or even purely accidentally, were preserved because they enabled the group in which they have arisen to prevail over others” (Hayek 1973, p. 9).

An interesting and fundamental question arises regarding Hayek's notion of cultural or social evolution: what role does it play for his ‘economics and philosophy of liberty’? Is it an indispensable part which cannot be disassociated or is it ‘merely’ an additional and auxiliary argument which reinforces his ‘economics and philosophy of liberty’, but which is not necessary for his entire framework? Can his work stand on its own without evolutionary arguments? Evolutionary arguments, if not a full-

with below) is excluded, even regarded as endangering liberty. A quotation may show Hayek's (rather idyllic) understanding of liberty: “The courtier living in the lap of luxury but at the beck and call of his prince may be much less free than a poor peasant or artisan, less able to live his own life and to choose his own opportunities for usefulness” (Hayek 1960, CL, p. 17).

blown evolutionary theory, can also be found in his earlier work (cf. Caldwell 2000). But they did not play such an important role until his later work. Though Vanberg (1994b) warns of giving too much attention to evolutionary arguments in his later work, especially those formulated in his last work *The Fatal Conceit*, my above questions must be addressed given that the evolutionary arguments were present also in his earlier work.

In my view, this means a shift of his view from ordoliberalism to neoliberalism (This might constitute a greater transformation of Hayek than was recorded by Caldwell (1988)). This means giving up his “positive task of improving institutions”. This also means abandoning the lessons which he acquired from classical economics and which he shared with Robbins in that his theory of evolution is another version of natural harmony between private and public interests which Hayek criticized as a false interpretation of classical economics. In contrast, his cultural evolution turns out to be not that different from natural selection in the end (see below).

His theory of cultural evolution serves to constitute self-regulating market, albeit in a different way from mainstream economics. Polanyian embeddedness means that economic system must be embedded in the social system and not the other way around. In order to prevent undesirable interferences from without (from political and social system), it must be argued by Hayek that market economy is inherently and ‘automatically’ ‘embedded’ in society. Admittedly, the Hayekian market is not a self-regulating market in a neoclassical sense. What Hayek constantly emphasizes is that market economy needs institutional bases (which comprise moral, custom, tradition, law etc.). In the Hayekian framework they do not, however, alter the nature and working mechanism of market economy in any substantial way. One might argue that the approach of Hayek, Polanyi and OIE in this regard is analogous in their view that market economy needs institutional bases or frameworks. But this overlooks a wholly different nature of ‘embeddedness’ which can be found in Polanyi and OIE on the one hand and Hayek on the other.

In recent two decades there has been growing interest in applying insights from evolutionary theories in biology to explain economic and social phenomena. Recent

revival or rediscovery of evolutionary arguments reflects an aspect in economics which in one form or another existed from Adam Smith.¹⁵⁹ At the moment there are different, partly complementary and partly competing approaches to evolutionary economics including neo-Schumpeterian approach of Nelson and Winter, institutionalist approach following Veblen¹⁶⁰ (and to a lesser degree Commons¹⁶¹), and the Austrian approach stemming from Menger¹⁶². Interest on the evolutionary approach in economics is also related to the recognition that the narrow focus in the previous development of (mainstream) economics on physics has lead to theories which cannot properly explain economic and social phenomena. For some economists mainstream economics can be enriched and complemented by introducing evolutionary arguments; for others evolutionary economics provides basis for alternative to mainstream economics (most literature based on OIE belongs to this category).

Although, as early as 1952, Edith Penrose (1952 and 1953) was critical of some ways of using evolutionary arguments in economics as they were used to justify some unrealistic assumptions by neoclassical economists (Alchian 1950 and 1953; Friedman 1953).¹⁶³ It might be argued that they can be used to criticize shortcomings of mainstream economics and as a building block for constructing alternative theories. It is not that evolutionary arguments are (re)introduced to economics but how they are used that is the most fundamental question which must be borne in mind when dealing with evolutionary ideas in economics.

Underlying reasoning of Hayekian evolutionism: against rationality

Hayek's theory of cultural (or social) evolution is clear evidence that evolutionary arguments can be utilized to criticize neoclassical economics *and* at the same time to

¹⁵⁹ Hodgson (1993a) attempted at taxonomy of evolutionary ideas in economics from Adam Smith and Malthus over Veblen and Menger to Schumpeter and Hayek. It is not clear, however, to what extent the classification according to the criteria of developmental and genetic, ontogenic and phylogenetic offers some insights for further development of evolutionary economics without paying too much attention to biological sciences and committing the same mistake that neoclassical economists made by relying heavily on physical sciences.

¹⁶⁰ Cf. Jennings and Waller (1994); Rutherford (1998).

¹⁶¹ Cf. Ramstad (1994).

¹⁶² Cf. Prisching (1989). Haller (2000) points to some important differences between Menger's theory of institution and evolution and Hayek's theory.

¹⁶³ I shall deal in more detail below with controversy between Alchian and Penrose and its relevance for the interpretation of Hayek's evolutionism.

bolster a core neoclassical reasoning of equilibrium, modified by him as spontaneous order, and, thus, to justify a (neo)liberal policy stance. Hayek's evolutionary theory is a part of his grand project of constructing 'economics and philosophy of liberty' by extracting elements of constructivist rationalism from neoclassical economics. As I argued above, by his contact with neoclassical socialists he came to realize that neoclassical economics is susceptible to constructivist rationalism, which is for Hayek *the* intellectual origin of totalitarianism and socialism. Hayek's odyssey to curb this kind of rationalism, which for him is a most dangerous enemy for individual liberty, and to construct a economic and social theory which is free from it ('economics and philosophy of liberty') led him to introduce knowledge and institutional arguments. These arguments are supplemented by evolutionary arguments to constitute an analytically consistent whole. Via knowledge arguments Hayek tried to demonstrate that individuals cannot be fully rational in economic as well as social action since they are not endowed with perfect knowledge. Hayek's rationality seems to mean system rationality in this context, which does not coincide with individual rationality. Hayek's theory can be interpreted as grounding system rationality differently from neoclassical economics which assumes the (inherent and automatic) coincidence of individual and system rationality. What is important for Hayek is that system rationality is hidden for acting individuals who nonetheless contribute to it via unintended consequences of their interactions: individuals have no direct access to system rationality and thus have no means of influencing, modifying or reforming the system as a whole.¹⁶⁴ In this perspective Hayek's critique of constructivist rationalists is tantamount to saying that they presume to have direct knowledge of system rationality with which they can 'manipulate' the system. The reconciliation of system rationality and individual rationality (which may be seen to be analogous to the problem of harmony of private and public interests) can be achieved roughly in three ways¹⁶⁵: neoclassical manner of reducing system rationality to individual rationality where coincidence is always and ex-ante guaranteed; Hayekian and Smithian invisible hand explanation of individual rationality being led to system ra-

¹⁶⁴ This demonstrates also that Hayek's methodological individualism cannot be similar to that adopted by mainstream economics.

¹⁶⁵ I adapted Denis' (2003) formulations of relationship between properties at the individual (micro) level and those at the (macro) system level to my context of individual and system rationality.

tional; Keynesian and institutionalist way of system rationality inducing reconstruction of individual rationality.

In qualifying the view that methodological individualism is correlated with *laissez-faire* policy stance, Denis (2003) pointed out that there are two possible ways of methodological underpinning of *laissez-faire*: one is individualistic and the other is not. The former is the neoclassical way of reductionism and the latter is the Hayekian and Smithian way of explaining emergent order by individual hand mechanism.

“Advocates of *laissez-faire* face a choice: either one can ignore the disjuncture between levels, and adopt a through-going individualist methodology and policy stance – this seems to be the line taken by ... Lucas and by Friedman – or with Hayek and Adam Smith one can accept that disjuncture and adopt a non-individualist methodology but at the same time postulate a mechanism reconciling that methodological non-individualism with a *laissez-faire* policy individualism. Such a mechanism is an invisible hand mechanism. The invisible hand allows us to say, granted that social outcomes are not *logically* bound to reflect individual behavior in an aggregative, summary manner, nevertheless a mechanism exists which ensures that *in practice* they do so. The invisible hand is what allows us to think, and act, in an individualist way in a non-individualist world: it underpins individualism by tacitly conceding the opposite. *Laissez-faire* is vindicated and we are inveigled into tying the visible hand behind our back, if we can be persuaded that the invisible hand will do its job instead, and do it better” (Denis 2003, p. 223, emphasis in the original).¹⁶⁶

Thus, it is not an exaggeration to compare the individual hand explanation to Hegel’s notion of cunning of reason, which Hayek, as a critique of Hegel as in company with Marx and other historicists, would not endorse.¹⁶⁷

Hayek tried to demonstrate that individuals do not act for the sake of socially desirable outcomes, but that nonetheless their interactions pursuing their own purposes would contribute and lead to them: that is, to show that unintended consequences of

¹⁶⁶ Denis (2003, pp. 224-5) argues further: “The alternative to both of these *laissez-faire* approaches is to combine recognition of the non-individualistic nature of the world we live in which acceptance that there is no invisible hand. In this view, rational individual self-seeking behavior is by no means the necessary and sufficient micro substrate for the desirability of social outcomes. Rather, behavior must be *directly* social if desirable social outcomes are to be obtained. According to Keynes, for example, egoistical activity uncoordinated by the state may lead to inefficient outcomes.”

¹⁶⁷ On the relation between Hegel and Hayek in this regard see Ullmann-Margalit (1978 and 1998); Kukathas (1989, pp. 92ff.); Bellamy (1994, p. 433).

interactions of individuals are mostly desirable rather than the opposite. According to Hodgson this is a major reason why Hayek subscribed to the tradition of Scottish moral philosophers, downplaying Darwin and Malthus, another important contemporary line of evolutionary thinking.

“Malthus turned the view of Mandeville and the Scottish School upside down. While Mandeville and others argued that a healthy economic system could arise from individual greed and vice, Malthus saw that healthy individuals could create catastrophic results. Malthus thus offered the spectacle of healthy procreating leading to overcrowding and death, rather than Mandeville’s more comforting picture of the public benefits of vice, and Smith’s vision of ongoing economic growth. Darwin’s revolution involved a synthesis of these apparently contradictory viewpoints into a dynamic whole, where death and vitality played host to each other” (Hodgson 2004, p. 295).

Hayek’s main message is that individuals cannot and must not be made responsible for system rationality in the sense of socially desirable outcomes: doing so is the best way of brining constructivist rationalism into play again. How serious it is to exorcise this kind of rationalism is evidenced by his explicit critique of his mentor Mises in this regard, which belongs to rare cases.¹⁶⁸ In the foreword to a new edition of Mises’ *Socialism*, Hayek made clear his uneasiness with Mises’ statement of his basic philosophy which reads:

“It [Liberalism] regards all social cooperation as an emanation of rationally recognized utility, in which all power is based on public opinion, and can undertake no course of action that would hinder the free decision of thinking men” (Mises 1936/1981, p. 418).

Hayek (1978/1981, pp. xxiii-xxiv; emphasis in the original) remarked on this:

“It is the first part of this statement only which I now think is wrong. The extreme rationalism of this passage, which as a child of his time he could not escape from and which he perhaps never fully abandoned, now seems to me factually mistaken. It certainly was not rational insight into its general benefits that led to the spreading of the market economy. It seems to me that the thrust of Mises’ teaching

¹⁶⁸ Hutchison (1994, p. 231) pointed out that Hayek reserved with his criticism on Mises due to respect for his mentor in spite of obvious differences over methodological standpoints and argued: “The cause of political and economic freedom, to which Hayek devoted his intellectual career, could not, in the longer, and even in the shorter run, have been fought on the basis of the doctrines of his original teacher Wieser, or his mentor of a decade, Mises. Though it was a difficult and tortuous transition or escape, Hayek had to make it ...”

is to show that we have *not* adopted freedom because we understood what benefits it would bring: that we have *not* designed, and certainly were not intelligent enough to design, the order which we now have learned partly to understand long after we had plenty of opportunity to see how it worked. Man has *chosen* it only in the sense that he has learned to prefer something that already operated, and through greater understanding had been able to improve the conditions for its operation.”

This shows how eager Hayek was to ground his ‘economics and philosophy of liberty’ on non-rationalism (or evolutionary rationalism after he had abandoned the term “irrationalism”) which contradicts Misesian liberalism. It is interesting to note that followers of Mises’ thought are prone to extreme libertarianism.¹⁶⁹ Nonetheless, Misesian critique of Hayek may not be overlooked because it points to contradictions in Hayek: his rationalistic formulation of ideal society, and his recourse to spontaneous ordering forces and evolutionary selection processes which leave little room for reforming or changing society even in the direction of his ideal society.¹⁷⁰ For Kukathas (1989), the contradiction is due to Hayek’s dual basis on two different philosophies of liberalism: Humean and Kantian. The thrust of Misesian arguments is that since we know merits of market economy compared with socialism and demerits of government interference compared with non-interventionism we do not need to resort to Hayekian (agnostic) evolutionary arguments to constitute a liberal economic theory.¹⁷¹ Hence, the Misesian critique of Hayekian evolutionism:

“However, an actor *cannot* recognize the *indirect* consequences of his actions (and it is allegedly these unconscious, unintended consequences for society as a whole which are decisive for the evolutionary success or failure of individual practices). And since *these* consequences *cannot* be known, the proc-

¹⁶⁹ For a Misesian critique of Hayek’s theory of government and social evolution see Hoppe (1994)

¹⁷⁰ In a rather polemical way Hoppe (1994, p. 78) asserted: “Hence Hayek’s theory leads to an inescapable dilemma: If one applies Hayek’s theory to itself, then his own activity of writing books is nothing but a purposeless emanation regarding which the questions of true or false and of success or failure simply do not arise. Or Hayek’s writing represents a purposeful action. In this case his theory is obviously false, however, because in enlightening himself (and us) regarding the course of social evolution, Hayek no longer acts spontaneously but instead tries to shape social change consciously and rationally.”

¹⁷¹ For Mises’ view on rationalism and social evolution and its comparison with Hayek, see Salerno (1990). According to Salerno (1990, pp. 26f.), Mises’ view is that “all social interactions and relationships are thought out in advance and that therefore, society originates and evolves as a product of reason and teleological striving, as a “man-made mode of acting” and a consciously devised “strategy”, that “law, normative rules of conduct, and social institutions are at one and the same time the product of a long evolutionary process and the outcome of attempts by individual human beings to rationally and purposively adjust their behavior to the requirements of social cooperation under division of labor”.

ess of social evolution is ultimately irrational, motivated not by true or false ideas and insights, but by a blind, unconsciously-effective mechanism of group selection” (Hoppe 1994, p. 80: italics in the original).

This difference is also reflected in the controversy among Austrian economists as to whether contribution of Hayek and that of Mises to SCD are similar and complementary or rather different in kind than in degree.¹⁷² In our context it suffices to say that Hayek opted for ‘agnostic-evolutionary’ arguments in contrast to Misesian ‘rationalistic-evolutionary’ arguments¹⁷³ to constitute his ‘economics and philosophy of liberty’ mainly because of his concern with ‘abuse of reason’.

Concurrent evolution of mind and society

Hayek’s last blow to constructivist rationalism in terms of evolutionary argument is his suggestion that mind itself is a product of evolution (another blow in terms of ‘institutional’ argument may be that mind follows rules and does not create them). Hayek emphasized this at various places:

“The errors of constructivistic rationalism are closely connected with Cartesian dualism, that is with the conception of an independently existing mind substance which stands outside the cosmos of nature and which enabled man, endowed with such a mind from the beginning, to design the institutions of society and culture among which he lives. The fact is, of course, that this mind is an adaptation to the natural and social surroundings in which man lives and that it has developed in constant interaction with the institutions which determine the structure of society. Mind is as much the product of the social environment in which it has grown up and which it has not made as something that has in turn acted upon and altered these institutions. It is the result of man having developed in society and hav-

¹⁷² I will not go into the detail of this controversy among Austrian economists on the complementarity or distinctiveness of contributions of Hayek and Mises to SCD respectively.

¹⁷³ Mises wrote in his *Human Action: A Treatise on Economics*: “The law of association makes us comprehend the tendencies which resulted in the progressive intensification of human cooperation. ... The task with which science is faced in respect of the origins of society can only consist in the demonstration of those factors which can and must result in association and its progressive intensification. ... If and as far as labor under the division of labor is more productive than isolated labor, and if and as far as man is able to realize this fact, human action itself tends toward cooperation and association; man becomes a social being not in sacrificing his own concerns for the sake of a mythical Moloch, society, but in aiming at an improvement in his own welfare. Experience teaches that this condition – higher productivity achieved under the division of labor – is present because its cause – the inborn inequality of men and the inequality in the geographical distribution of the natural factors of production – is real. Thus we are in a position to comprehend the course of social evolution” (quoted from Salerno (1990, p. 30).)

ing acquired those habits and practices that increased the chances of persistence of the group in which he lived. The conception of an already fully developed mind designing the institutions which made life in society possible is contrary to all we know about the evolution of man” (Hayek 1973, LLL 1, p. 17).

“Cultural evolution is not the result of human reason consciously building institutions, but of a process in which culture and reason developed concurrently *It is probably no more justified to claim that thinking man has created his culture than that culture created his reason. ... mind and culture developed concurrently and not successively*” (Hayek 1979, LLL 3, p. 155 and 156; italics in the original).

“It is ... misleading to represent the individual brain or mind as the capping stone of the hierarchy of complex structures produced by evolution, which then designed what we call culture. The mind is embedded in a traditional impersonal structure of learnt rules, and its capacity to order experience is an acquired replica of cultural patterns which every individual mind finds given. *The brain is an organ enabling us to absorb, but not to design culture*” (Hayek 1979, LLL 3, p. 157; italics in the original):

Though Hayek acknowledges mutual influence of mind and institutions qua social environment, his focus is on the aspect of institutions ‘forming’ mind and neglects the way how mind change institutions.

Relation between institutional and evolutionary arguments

I argued above that Hayek introduced institutional arguments to refine his critiques of socialism and to extend them to constitute his theory of FME qua formal embeddedness. With it he was able to criticize the narrow scope of maximizing rationality of neoclassical economics (based on non-embeddedness) which could lend support to market socialism. At the same time he could present rule-following behavior as an alternative to maximizing behavior and institutions as embodiment of generations of knowledge and experience giving orientation to interactions of individuals, which has an institutionalist ring. Thus, the market economy works only properly within distinctive institutional contexts which cannot be provided in market socialism. For the sake of his theory of FME qua formal embeddedness he needed evolutionary arguments which, without recourse to constructivistic rationalism, could

(only apparently) establish *loose-embeddedness* in terms of formal embeddedness (not in terms of substantive embeddedness) in that only those rules and institutions would be selected for which underpin and not ‘interfere with’ the proper working of FME.¹⁷⁴ Insofar as he acknowledged that evolution must not necessarily mean progress (toward great society) and that institutional (primarily legal) reforms are necessary (but not according to directly recognizable system rationality (of survival) but according to indirect way of “immanent criticism”), he failed to establish universality of the FME in the sense that it is the only form which a functioning market economy can take. The only consistent way of resolving this tension would be to accept FME as a loose-embeddedness (that is a specific case of substantive-embeddedness), which Hayek could not do without undermining his ‘economics and philosophy of liberty’ basing as it does on the narrow definition of Hayek’s individual liberty: his liberty view of market economy cannot accommodate instrumentalist view of market economy which substantive-embeddedness entails.¹⁷⁵ Hayek’s evolutionary arguments aim at universalizing institutional contexts which, in his view, are necessary for the working of FME and, thus, to establish the impossibility or infeasibility of SME as well as of socialism.

With institutional arguments alone he cannot establish universality of institutions underpinning FME, nor can he exclude constructivistic rationalism. In the context of institutional arguments he criticized the natural harmony and laissez-faire interpretation of classical economists. According to him, they conceived that harmony between private and public interests can be achieved only by ‘canalization’ by institutions (which is equivalent to Robbins’s and Samuels’s interpretation of classical economics: see above). In this context, Hayek emphasized positive task of improving institutions. However, his evolutionary arguments reintroduced ‘natural harmony’ through the back door. I will try to show below that Hayek’s arguments is susceptible to naturalistic fallacy and perhaps to social Darwinism in spite of his contrary

¹⁷⁴ See above Ch. 2, *substantive embeddedness vs. formal embeddedness*, and below Ch. 7.

¹⁷⁵ If FME as loose-embeddedness is established, one cannot reject or criticize SME as tight-embeddedness because they are just two different forms of substantive embeddedness.

assertion. His evolutionary arguments can thus be seen as extending and bolstering invisible hand explanation.¹⁷⁶ I shall show that he failed to establish his case.

Role of evolutionary arguments

When introducing evolutionary arguments into his ‘economics and philosophy of liberty’, Hayek had to explain firstly why we need evolutionary theory in economics and social sciences and, secondly, in which and to what extent it differs from evolutionary theory in biology. It is evident that Hayek’s evolutionary arguments serve to strengthen his case against constructivistic rationalism and to underpin his case for a third realm beyond the dichotomy of the natural and the artificial which means orders can arise without design.¹⁷⁷ That is, “a distinct third class of phenomena” epitomized by Adam Ferguson as ‘the result of human action but not of human design’. (Hayek 1973, LLL 1, p. 20).

It becomes more evident as Hayek grounded his theory of liberty on the “British tradition” of liberalism which he contrasted to that of “French tradition”:

“[T]he first based on an interpretation of traditions and institutions which had spontaneously grown up and were but imperfectly understood, the second aiming at the construction of a utopia, which has often been tried but never successfully. Nevertheless, it has been the rationalist, plausible, and apparently logical treatment of the French tradition, with its flattering assumptions about the unlimited powers of human reason, that has progressively gained influence, while the less articulate and less explicit tradition of English freedom has been on the decline” (Hayek 1960, CL, pp. 54-5).¹⁷⁸

¹⁷⁶ Cf. Dennis (2003, p. 224): “For Hayek ... the invisible hand mechanism takes the form of an evolutionary process, specifically the group selection theory” For more on this see below.

¹⁷⁷ Cf. Hayek (1976, LLL 2, p. 191, n. 13): “The constructivist prejudice which still makes so many socialists scoff at the ‘miracle’ that the unguided pursuit of their own interests by the individuals should produce a beneficial order is of course merely the reverse form of that dogmatism which opposed Darwin on the ground that the existence of order in organic nature was proof of intelligent design.”

¹⁷⁸ Cf. Hayek (1960, CL, pp. 55-6): “What we have called the “British tradition” was made explicit mainly by a group of Scottish moral philosophers led by David Hume, Adam Smith, and Adam Ferguson, seconded by their English contemporaries Josiah Tucker, Edmund Burke, and William Paley, and drawing largely on a tradition rooted in the jurisprudence of the common law. Opposed to them was the tradition of the French Enlightenment, deeply imbued with Cartesian rationalism; the Encyclopedists and Rousseau, the Physiocrats and Condorcet, are their best-known representatives.” According to Hayek there are some cases which do not fit into the division according to national boundaries: there are French representatives of British tradition such as Montesquieu, Benjamin Constant, Alexis de Tocqueville; and British representatives of French tradition such as Thomas Hobbes, Godwin, Priestley, Price, and Paine.

There is a fundamental difference between “their respective conceptions of the evolution and functioning of a social order and the role played in it by liberty” from which their different political conclusions stem (ibid, p. 56). The British tradition finds the origin of institutions “not in contrivance or design, but in the survival of the successful” (ibid, p. 57). Scottish-British philosophers came by their “anti-rationalistic insight” “for the first time to comprehend how institutions and morals, language and law, have evolved by a process of cumulative growth and it is only with and within this framework that human reason has grown and can successfully operate. Their argument is directed throughout against the Cartesian conception of an independently and antecedently existing human reason that invented these institutions and against the conception that civil society was formed by some wise original legislator or an original “social contract”. The latter idea of intelligent men coming together for deliberation about how to make the world anew is perhaps the most characteristic outcome of those design theories” (ibid., p. 57).

They showed how “purposive institutions might grew up which owed little to design, which were not invented but arose from the separate actions of many men who did not know what they were doing” (ibid., pp. 58-9). They showed for the first time that an evident order need not be explained either as the product of human designers or as a product of nature or deity but that there was a third possibility: “the emergence of order as the result of adaptive evolution” (ibid., p. 59):

“Rules for his conduct which made him adapt what he did to his environment were certainly more important to him than ‘knowledge’ about how other things behaved. In other words: man has certainly more often learnt to do the right thing without comprehending why it was the right thing, and he still is often *served better by custom than by understanding*” (Hayek 1979, LLL 3, p. 157: italics added).

Cultural evolution vs. social Darwinism

To make his case for introducing evolutionary arguments Hayek differentiated his theory of social or cultural evolution from theory of biological evolution and dealt with similarities and differences between them. It was important for Hayek to point

out that evolutionary ideas were developed in social science earlier than in biology, that evolutionary arguments in social sciences must not lead to social Darwinism. Therefore, for Hayek, the well-known shortcomings of social Darwinism must not be used as a justification for renouncing evolutionary ideas in social sciences.

“Since the emphasis we shall have to place on the role that selection plays in this process of social evolution today is likely to create the impression that we are borrowing the idea from biology, it is worth stressing that it was, in fact, the other way around: there can be little doubt that it was from the theories of social evolution that Darwin and his contemporaries derived the suggestion for their theories” (Hayek 1960, CL, p. 59).

In 1973 Hayek tried to make this point more clearly:

“[I]t is important to clear up some misunderstandings which in recent times have made students of society reluctant to employ it. The first is the erroneous belief that it is a conception which the social sciences have borrowed from biology. It was in fact the other way around It was in the discussion of such social formations as language and morals, law and money, that in the eighteenth century the twin conceptions of evolution and the spontaneous formation of an order were at last clearly formulated, and provided the intellectual tools which Darwin and his contemporaries were able to apply to biological evolution”¹⁷⁹ (Hayek 1973, LLL 1, pp. 22-3).

Hayek even described those 18th moral philosophers (Mandeville, Hume, Adam Smith, and Adam Ferguson)¹⁸⁰ and the historical schools of law and language (Humboldt, von Savigny) who contributed to evolutionary conceptions in social sciences as “Darwinians before Darwin” (Hayek 1973, LLL 1, pp. 23, p. 153).¹⁸¹

In this way Hayek established his claim that there is a right and legitimate place for evolutionary theory in social sciences:

¹⁷⁹ See also Hayek (1988, FC, p. 24): “Darwin’s work was preceded by decades, indeed by a century, of research concerning the rise of highly complex spontaneous orders through a process of evolution.”

¹⁸⁰ Cf. Hayek (1988, FC, p. 146): “From the Scottish moral philosophers of the eighteenth century stem the chief impulses towards a theory of evolution, the variety of disciplines now known as cybernetics, general systems theory, synergetics, autopoiesis, etc., as well as the understanding of the superior self-ordering power of the market system, and of the evolution also of language, morals, and law.”

¹⁸¹ See also Hayek (1979, LLL 3, p. 154): “Indeed, the idea of cultural evolution is undoubtedly older than the biological concept of evolution. It is even probable that its application by Charles Darwin to biology was, through his grandfather Erasmus, derived from the cultural evolution concept of Bernard Mandeville and David Hume, if not more directly from the contemporary historical schools of law and language.”

“If Charles Darwin was able successfully to apply to biology a concept which he had largely learned from the social sciences, this does not make it less important in the field in which it originated” (Hayek 1973, LLL 1, p. 23).

Thus, for Hayek, it is unfortunate that the social sciences failed to build on these beginnings in their own field, but “re-imported some of these ideas from biology and with them brought in such conceptions as “natural selection,” “struggle for existence,” and “survival of the fittest,” which are not appropriate in their field” (Hayek 1960, CL, p. 59). He went so far as to say that “A nineteenth-century social theorist who needed Darwin to teach him the idea of evolution was not worth his salt” (Hayek 1973, LLL 1, p. 23).

Hayek thought that social Darwinism, which for Hayek resulted from a false re-import of evolutionary conception from biology, discredited its application in the social sciences in which it originated, that the inappropriateness of social Darwinism is often used by constructivistic rationalists as “a pretext for rejecting any evolutionary approach at all” (Hayek 1988, FC, p. 27). According to Hayek social Darwinists overlooked the fundamental difference between biological evolution and social or cultural evolution:

“[I]n social evolution, the decisive factor is not the selection of the physical and inheritable properties of the individuals but the selection by imitation of successful *institutions* and *habits*. Though this operates also through the success of individuals and groups, what emerges is not an inheritable attribute of individuals, but *ideas* and *skills* – in short, the whole *cultural inheritance* which is passed on by learning and imitation” (Hayek 1960, CL, p. 59; italics added).

Group selection

For Hayek, the most important distinction between biological and social evolution is that between genetic transmission of individual characteristics on the one hand, and, on the other, the cultural transmission of socially formed and learned institutions and practices. Thus, it is for Hayek a great failure of social Darwinists not to have recognized this. One important consequence is that for Hayek selection units are not individuals but groups: Those groups that adopted effective institutions would sur-

vive in the end. Inappropriate rules and morals would die out as the groups that adopted them are outnumbered by other groups with more effective (efficient) institutions: “Within any given society, particular groups will rise or decline according to the ends they pursue and the standards of conduct that they observe. And the ends of the successful group will tend to become the ends of all members of the society” (Hayek 1960, CL, p. 36). As Hayek rightly pointed out, it is not relevant here whether group selection also operates in biological evolution. The more important question in this regard is whether Hayek’s theory of group selection does not fit with his methodological individualism¹⁸² (see below).

The notion of group selection, operating as competition between groups with different rules and institutions, delivers to Hayek arguments on explanation of how there can be improvement of institutions and progress of human civilization without deliberate design and reform based on some kind of reason. Institutions that survive, spread and are imitated by increasing numbers of individuals and groups do so, by giving the groups adopting them a competitive edge over other groups with ‘inferior’ institutions. Cultural evolution is, thus, a process of successive replacement of instincts or innate rules by learned rules appropriate for civilization¹⁸³ and successive replacement of ‘inferior’ rules for simple order by ‘superior’ rules for complex or extended order like market order without the acting individuals consciously aiming at that:

“To understand our civilization one must appreciate that the extended order resulted not from human design or intention but spontaneously: it arose from unintentionally conforming to certain traditional and largely *moral* practices, many of men tend to dislike, whose significance they usually fail to understand, whose validity they cannot prove, and which have nonetheless fairly rapidly spread by means of an evolutionary selection – the comparative increase of population and wealth – of those groups that happened to follow them. The unwitting, reluctant, even painful adoptions of these practices kept these groups together, increased their access to valuable information of all sorts, and en-

¹⁸² Cf. Vanberg (1986) and Hodgson (1993c).

¹⁸³ Cf. Hayek (1979, LLL 3, p. 155): “Civilization has largely been made possible by subjugating the innate instincts to the *non-rational customs* which made possible the formation of larger orderly groups of gradually increasing size”; Hayek (1988, FC, p. 17): “The decisive change from animal to man was due to such culturally-determined restraints on innate responses.”

abled them to be ‘fruitful, and multiply, and replenish the earth, and subdue it’ (Genesis I: 28)” (Hayek 1988, FC, p. 6).

“The structures formed by traditional human practices are neither natural in the sense of being genetically determined, nor artificial in the sense of being the product of intelligent design, but the *result of winnowing or sifting, directed by the differential advantages gained by groups from practices adopted for some unknown and perhaps purely accidental reasons*” (Hayek 1979, LLL 3, p. 155; italics added).

“It is in the pursuit of man’s aims of the moment that all the devices of civilization have to prove themselves; the ineffective will be discarded and the effective retained” (Hayek 1960, CL, p. 36).

Hayek even argues that man was civilized against his wishes: an argument Hayek used as a basis of his critique of social justice as an atavism, with which I shall deal with below (Ch. 6).

Hayek’s methodological individualism is different from that of neoclassical theory in which asocial and atomized individuals are conceived. Individuals are social animals for Hayek, but he did not explain evolution of rules in terms of individual motivations. His version of methodological individualism requires to answer the question why individuals will follow rules when they do not know why. According to Hayek, individuals do not have ex-ante knowledge of benefits of certain rules for their purposes even though the rules would lead the group to which they belong to survive in the competition. As Denis (2003, p. 224) puts it:

“The point is, not that it is impossible for behavior which leads to desirable consequences for the group to emerge, but that such behavior needs to be underpinned by individual incentives. The theory of group selection – whether in a biological or social context – suggests that process will be selected for when they lead to desirable collective outcomes. But it does not provide any mechanism linking those desirable processes to individual interests. The question, why individuals should act in the manner required by the theory, is left unanswered.”¹⁸⁴

¹⁸⁴ See also Haller (2000, pp. 549-550): “In order to escape the reproach of obscurantism, Hayek needs to indicate a causal link between the “prosperity” or the “chances of the survival” of the group, on the one hand, and the individual motivations of the group members, on the other. Would he say that the group members’ belief that the rule is collectively beneficial sufficiently motivates their compliance and therefore their support for the authority that enforces the rules? No, because that would imply a constructivist ... explanation of the persistence of rules or institutions.” Khalil (2000, p. 377) argues in a similar vein: “While Schumpeter did not appeal to Darwinian evolutionary biology to advance his evolutionary economics, Friedrich Hayek made such an explicit appeal

Evolution and rule-following behavior

Several commentators point to the awkward relationship between Hayek's methodological stance and his theory of (cultural evolution via) group selection. That a strict version of methodological stance is not compatible with group selection is much less controversial than the question of to what extent Hayek subscribed to methodological individualism and which type of it, if any, Hayek adopted. For if Hayek's methodological stance cannot be shown to be that of methodological individualism in a strict sense, the critique of inconsistency or contradiction between his overall methodology and his theory of group selection becomes all of sudden irrelevant, which clarifies some differences in Hayek scholarship. Vanberg (1986), on the one hand, and Hodgson (1993c), on the other, suggest different consequences from this alleged contradiction, while they have in common that Hayek adopted methodological individualism which did not fit well with his theory of group selection. For Vanberg the theory of group selection must be so modified as to accommodate individualism whereas for Hodgson it is methodological individualism of Hayek that must be sacrificed for the sake of group selection theory which, according to him, is applicable to both biological and social phenomena. For both scholars, however, Hayek is a methodological individualist.

However, Hayek was not a methodological individualist, at least in a strict neoclassical sense where atomized, institution-free, instantly and constantly rationalizing individuals are conceived. In a controversy between Caldwell and Hodgson, the former pointed this out and the latter qualified his interpretation of Hayek as methodological individualist.¹⁸⁵ Recently, Caldwell (2002) seems to go as far as to suggest that Hayek is not a methodological individualist at all. Given the fact that evolutionary approach gains more and more in scope and importance in Hayek's later works and given increasing remarks that Hayek was not a methodological individualist at least in the neoclassical sense, it seems quite reasonable for critics of Hayek to

to criticize rationalist thought which present the social order as the outcome of design rather than the outcome of evolution. However, Hayek's evolutionary mechanism is a variety of Darwinian selection theory and, hence, does not recognize the role of purposeful action. Hayek's use of the Darwinian mechanism invites inconsistencies in Hayek system"

¹⁸⁵ Cf. Caldwell (2001, pp. 548-551; 2004, pp. 303-4); Hodgson (2004, pp. 297-8)

turn their attention away from his methodological individualism. After all Hayek's transformation was induced by his realization of limits of mainstream approach of explaining general equilibrium of economy on the basis of maximizing rationality of individuals with perfect knowledge. His research project to which his participation in SCD gave decisive impetus was to constitute a theory of 'grand' socio-economic order in line with his liberalism beyond the reach of socialism and neoclassical economics.

I argued above that if we do not differentiate between Hayekian and neoclassical economics in criticizing the former, we are overlooking the real nature of Hayekian challenge to heterodox economics, especially to OIE. It is somewhat ironical that scholars favorable to Hayekian approach made this explicit. In a provocative sense, Hayek's theory of evolution embodies more institutionalism than OIE would admit¹⁸⁶: it is not based on methodological individualism but rather on a extreme form of institutionalism, that is institutional or cultural determinism tending toward methodological collectivism.¹⁸⁷ While classifying Hayek (and North) as new institutionalists Hodgson (1998b, p. 177, n. 9 and p. 185) remarks affinities of Hayek's evolutionary approach in his later works (and that of North¹⁸⁸) to OIE. But he overlooks the potential of Hayek's evolutionary approach as implying methodological collectivism.

According to Hodgson OIE stands between two extreme explanations on the relation between human agency and structure, in other words, the relation between individual behavior and social institutions. One is cultural or institutional determinism, and the other is NIE explaining institutions as stemming from interactions of 'given', 'institution-free' individuals based on mainstream rational choice approach. A central tenet of OIE approach, in contrast to both approaches, is that: "Individuals interact to

¹⁸⁶ Cf. Hodgson (1998b, p. 181): "Two opposite types of error are possible. The "cultural determinists" place too much stress on the molding of individuals by institutions. ... At the opposite end of the spectrum, the "new institutional economics" gives no more than weak stress to the processes of institutional conditioning, and focuses on the emergence of institutions out of the interactions of given individuals."

¹⁸⁷ In methodological collectivism "individual behavior is entirely explained by the institutional or cultural environment" (Hodgson 1998b, p. 172), which is roughly equivalent to oversocialized view of human action criticized by Granovetter (1985) as equally biased as undersocialized view in neoclassical economics.

¹⁸⁸ For an interpretation of North's economics as combining elements of neoclassical economics, NIE and OIE see Vandenberg (2002).

form institutions, while individual purposes or preferences also are molded by socio-economic conditions. The individual is both a producer and a product of her circumstances” (Hodgson 1998b, p. 177).

“The thrust of the “old” institutionalist approach is to see behavioral habit and institutional structure as mutually entwined and mutually reinforcing Choosing institutions as units of analysis does not necessarily imply that the role of the individual is surrendered to the dominance of institutions. A dual stress on both agency and structure is required Both individuals and institutions are mutually constitutive of each other. Institutions mold, and molded by, human action. Institutions are both “subjective” ideas in the heads of agents and “objective” structures faced by them. The twin concepts of habit and institution may thus help to overcome the philosophical dilemma between realism and subjectivism in social science. Actor and structure, although distinct, are thus connected in a circle of mutual interaction and interdependence” (Hodgson 1998b, pp. 180-1).

For Hodgson, NIE’s explanation of institutions from interaction of ‘given’ individuals assuming hypothetical, initial institution-free “state of nature” is subject to infinite regress¹⁸⁹ (Hodgson 1998b, p. 182 ff.).¹⁹⁰ Thus, neither can institutions be adequately explained exclusively in terms of individuals nor can individuals be adequately explained only in terms of institutions. While, therefore, for Hodgson “neither individual nor institutional factors have complete explanatory primacy”, he argues that institutions and individuals do not have equivalent ontological and explanatory status (Hodgson 1998b, p. 184) implying that institutions have priority over individuals in the end.¹⁹¹ He seems to suggest that focusing on the “institutionalizing function of institutions” (ibid, p. 171) and emphasizing a “coextensive process of enculturation” (ibid, p. 183) can break the circle of “the chicken or the egg” or “the

¹⁸⁹ A similar line of critique of explanations of markets and institutions by neoclassical economics and new institutional economics was made by Mirowski (1981).

¹⁹⁰ See Hodgson (1998b, p. 182): “In trying to explain the origin of social institutions from given individuals, the new institutional economics has to presume a social framework governing their interaction. In any original, hypothetical, “state of nature” from which institutions are seen to have emerged, a number of rules, and cultural and social norms are already presumed. No “thought experiment” involving an institution-free “state of nature” has yet been postulated without them.” This applies also for game theory: “There can be no games without prior rules, and thus game theory can never explain the elemental rules themselves. ... even with games about games about games to the nth degree there is still at least one preceding game left to be explained” (ibid).

¹⁹¹ Cf. Hodgson (1998b, p. 172): “The fact that institutions typically portray a degree of invariance over long periods of time, and my outlast individuals, provides reason for choosing institutions rather than individuals as a basic unit. Most institutions are temporarily prior to the individuals that relate to them. We are all borne into and socialized within a world of institutions.”

individual or the institution” type of the inquiry by conceiving “institutionalized individuals”: “Crucially, each individual is born into, and molded by, a world of pre-existing institutions: even if these institutions were made by others and can be changed” (ibid, p. 184): “We are all born into and socialized within a world of institutions” (ibid, p. 172).

This basic idea of “socialized individuals” is not a far cry from Hayekian evolutionary and institutional approach insofar as Hayek (1973, LLL 1, p. 17) wrote that “cultural heritage into which man is born consists of a complex practices or rules of conduct,” and as he argued:

“Every man growing up in a given culture will find in himself rules, or may discover that he acts in accordance with rules – and will similarly recognize the actions of others as conforming or not conforming to various rules. This is, of course, not proof that they are a permanent or unalterable part of ‘human nature’, or that they are innate, but proof only that they are part of a cultural heritage which is likely to be fairly constant ...” (Hayek 1973, LLL 1, p. 19).

Hodgson’s explanation of how individuals are molded by institutions (Hodgson 1998b, especially p. 180f.)¹⁹² and of what roles habits, rules and institutions play is similar to Hayek’s. What Hodgson overlooked in relating Hayek’s approach to OIE is that Hayek did not explain the other direction of the mutual process: how individuals mold and change institutions. In Hayek’s theory of spontaneous order and cultural evolution there is no clear-cut analysis of how institutions can be changed or modified by individuals. There are no roles left to individuals other than following traditions in a given institutional framework, which amounts to rather methodological collectivism or institutional determinism than methodological individualism or undersocialized view of individuals:

¹⁹² See Hodgson (1998b, p. 180): “Institutions are regarded as imposing form and social coherence upon human activity partly through the continuing production and reproduction of habits of thought and action. This involves the creation and promulgation of conceptual schemata and learned signs and meanings. Institutions are seen as a crucial part of the cognitive processes through which sense-data are perceived and made meaningful by agents”; Hodgson (1998b, p. 184): “It is not possible to understand how institutions are constructed without seeing individuals as embedded in a culture made up of many interacting institutions. Institutions not only constrain but also influence individuals.”

“We stand in a great framework of institutions and traditions – economic, legal, and moral – into which we fit ourselves by obeying certain rules of conduct that we never made, and which we have never understood in the sense in which we understand how the things that we manufacture function” (Hayek 1988, FC, p. 14).

The core message of Hayek’s theory of group selection is that human beings are civilized against their wishes.¹⁹³ Cultural evolution is a process of “gradual replacement of innate responses by learnt rules” (ibid, p. 16). Cultural evolution selects rules appropriate for emergence and sustenance of beneficial orders, whether they are termed by Hayek social order, market order, civilization, society or capitalism. With his theory of spontaneous order and cultural evolution Hayek attempted a grand discourse on the emergence of capitalism and its benefits. Indeed, for Hayek the fate of human civilization depends on the preservation of capitalism, which corresponds to Free Market Economy in my term (Hayek, 1988, FC, p. 6). Through group selection only those groups who happened to practice moral rules that sustain (free) market order survived and prospered (or in other words increased in population and wealth) and those who stuck to instinctive tribal rules disappeared.¹⁹⁴ Thus, traditions and morals which are products of evolutionary selection¹⁹⁵ and which sustain capitalism ought to be followed if human beings are to survive because to follow them is the only way for that. So, any deliberate change or design of rules which is attempted by socialists with their “constructivist fallacy” must lead to demise of civilization:

“If humankind owes its very existence to *one* particular rule-guided form of conduct of *proven effectiveness*, it simply does not have the option of choosing another merely for the sake of the apparent pleasantness of its immediately visible effects. The dispute between the market order and socialism is no less than a *matter of survival*. To follow socialist morality would destroy much of present humankind and impoverish must of the rest” (Hayek 1988, FC, p. 7; emphasis added).

¹⁹³ “*Man has been civilized very much against his wishes*” (Hayek 1979, LLL 3, p. 168; italics in the original).

¹⁹⁴ It is noteworthy that Hayek’s terms for rules seems to have unperceived shift in connotation and frequency of use from rules of (just) conduct to morals and traditions or ‘moral traditions’ and even simply to ‘morality’. Whereas morals were used as moral rules in contrast to legal rules, such contrast was not made in his last work (Hayek 1988, FC). There (ibid, p. 21) Hayek described evolution of the extended order as “cultural and *moral* evolution”.

¹⁹⁵ See Hayek (1988, FC, p. 52): “Morals, especially, our institutions of property, freedom and justice, are not a creation of man’s reason but a distinct second endowment conferred on him by cultural evolution.”

Moral traditions that are “requisite” for the emergence and preservation of market order according to Hayek include such various entities as private property, saving¹⁹⁶, exchange, honesty, truthfulness, contract, trade, competition, gain, privacy, freedom, justice (cf. Hayek 1988, FC, p. 12, p. 52 and p. 67). They are “evolved morality” that “created and sustains the extended order” without anyone intending or even desiring that and knowing the effect of following that morality¹⁹⁷:

“The extended order depends on this morality in the sense that it came into being through the fact that those groups following its underlying rules increased in numbers and in wealth relative to other groups. The paradox of our extended order, and of the market – and a stumbling block for socialists and constructivists – is that, through this process, we are able to sustain more from discoverable resources (and indeed in that very process discover more resources) than would be possible by a personally directed process. And although this morality is not ‘justified’ by the fact that it enables us to do these things, and thereby survive, *it does enable us to survive, and there is something perhaps to be said for that* (Hayek 1988, FC, p. 70; emphasis in the original).

This is a combination of his knowledge argument and evolutionary argument for market order: Evolved rules and institutions of capitalism which guarantee survival and facilitate economic progress represent also “embodiment of accumulated cultural knowledge” (Hayek 1988, FC, p. 58).

Thus, individuals are simply required or forced by the imperative of the survival of the system to submit to morals and traditions which they hate without knowing ex-ante how they affect or benefit them and without understanding how they function.¹⁹⁸

¹⁹⁶ Above I briefly dealt with Importance of ‘voluntary saving’ for Hayek’s capital and business cycle theory. Now Hayek refers to saving as one of those traditions and moralities which are indispensable for civilization and which were selected for by the cultural evolution.

¹⁹⁷ Cf. Hayek 1988, FC, p. 23: “Learnt moral rules, customs, progressively displaced innate responses, not because men recognized by reason that they were better but because they made possible the growth of an extended order exceeding anyone’s vision, in which more effective collaboration enabled its members, however blindly, to maintain more people and to displace other groups.”

¹⁹⁸ Cf. Hayek (1988, FC, p. 68): “If we stopped doing everything for which we do not know the reason, or for which we cannot provide a justification in the sense demanded [by Cartesian rationalism], we would probably very soon dead”; Hayek (1988, FC, p. 13f., italics added): “Constraints on the practices of the small group, it must be emphasized and repeated, are *hated*. For ... the individual following them, even though he depends on them for life, does not and usually cannot understand how they function or how they benefit him. He knows so many objects that seem desirable but for which he is not permitted to grasp, and he cannot see how other beneficial features of his environment depend on the *discipline to which he is forced to submit* – a discipline forbidding him to reach out for these same

Nonetheless, they lead to beneficial order in terms of survival of the structure or the system and in terms of increase of wealth through more efficient utilization of resources. Not all rules bring about beneficial outcomes, but only those rules that contribute to such outcomes are selected for by evolutionary process of group selection. ‘System rationality’ is given independently of ‘individual rationality’: The system (or order for that matter) accomplishes its task and has its own way behind the back of individuals. Paradoxically, this idea has affinity with the notion of ‘cunning of reason’ by Hegel whom Hayek abhorred so much.¹⁹⁹ According to Hayek, Hegel alongside Comte, in spite of their superficial differences (the one idealist, the other positivist) paved the way for collectivism and historicism with their abuse of reason²⁰⁰:

“Their historical determinism – by which is meant, not merely that historical events are somehow determined, but that *we* are able to recognize why they were bound to take a particular course – necessarily implies a through fatalism: man cannot change the course of history ... There is no room for freedom in such a system” (Hayek 1951, CRS, pp. 385-6).

However, it is difficult to understand to what extent and in what respect this view should be different from Hayekian ‘institutional-evolutionary’ determinism.

Individual motivation or choice is, thus, not related to the emergence and functioning of the system. While unintended consequences of action and interaction of individuals lead to favorable order and they indirectly and ex-post contribute to it, they could

appealing objects. Disliking these constraints so much, we hardly can be said to have selected them; rather, *these constraints selected us: they enabled us to survive.*”

¹⁹⁹ In comparing ‘invisible hand explanation’ with ‘cunning of reason’ Ullmann-Margalit, while pointing to some differences, summarizes “the point of contact”: “Both the doctrine of the invisible hand and the doctrine of the cunning of reason focus on the fact that the result of human action need not be the outcome of any human design. Moreover, both doctrines spring from the recognition that some unintended and unexpected consequences of human action may fulfill a purpose, may serve a valuable function, may lead to progress or to perfection” (Ullmann-Margalit 1998, p. 369). For the comparison between Hayek and Hegel see also Bellamy (1994, p. 433).

²⁰⁰ See Hayek (1951, CRS, pp. 392-3): “Hegel and Comte both singularly fail to make intelligible how the interaction of the efforts of individuals can create something than they know. While Adam Smith and the other Great Scottish individualists of the eighteenth century – even though they spoke of the “invisible hand” – provided such an explanation, all that Hegel and Comte give us is a mysterious teleological force. And while eighteenth-century individualism, essentially humble in its aspirations, aimed at understanding as well as possible the principles by which the individual efforts combined to produce a civilization in order to learn what were the conditions most favorable to its further growth, Hegel and Comte became the main source of that hubris of collectivism which aims at “conscious direction” of all forces of society.”

not have accomplished that consciously and intentionally or deliberately. Thus, they cannot change the course of the system deliberately. This missing link between the level of individual and the level of system in Hayekian evolutionary framework is due to Hayek's theory of group selection, which is indeed not compatible with methodological individualism. Vanberg, who is in principle favorable to methodological individualism, sees, thus, in Hayek's theory of evolution the free rider problem:

"After all, it is the individuals who are to adopt and to practice the behavioral regularities which are supposed to be selected ... though individuals who live in groups in which "appropriate" rules are practiced are better off compared to individuals that live in groups with "less appropriate" rules, within the groups those bearing the costs of socially beneficial but self-sacrificing behavior would be relatively *worse off* than those who *free* ride, who enjoy the group advantage without sharing the costs of its production. Hence, despite the between-group advantage without sharing the costs of its production. Hence, despite the between-group advantage from practicing "appropriate" rules, there would be a within-group disadvantage for those who actually practice them compared to those who free ride. It is true that in cultural evolution the free-rider problem can be overcome because men's capability deliberately to change the constraints under which they are acting so as to make adherence to socially beneficial practices individually advantageous. But incorporating these mechanisms into a theory of cultural evolution would mean to assign a significant role to organized, political processes and would not seem to leave much room for some autonomous process of group selection operating beyond the level of man's choice.

A theory of the emergence and persistence of cultural rules had to cope with the problem that group advantage as such simply cannot explain why the individuals within the group will actually exhibit such group-beneficial behavioral regularities, given the incentive to free ride" (Vanberg 1986, pp. 87-8).

In Hayekian scheme, however, an explicit (or full-blown) free-rider problem does not arise simply because individuals do not follow rules for the sake of group advantage. In fact they cannot differentiate on any ex-ante ground between appropriate and inappropriate rules. The differentiation between them is 'offered' by the process of evolutionary selection. Nonetheless Vanberg (ibid, p. 83) is right in pointing out:

"To refer to group advantage rather than to individual benefits ... rather sounds like the *functionalist* type of argument, according to which its contribution to the "maintenance" of a social system explains the existence of a social pattern or institution."

For Hayek individuals are socialized or institutionalized so that individual incentive might play a secondary role. More important for Hayek is to establish that individuals do not choose to follow rules on the basis of rationalistic consideration on the effects of the rules, which would imply that they could also be changed on that basis, which Hayek cannot accept.

Hayek was conscious that there can be a problem establishing links between the level of individual and the level of order by cultural evolution and asked himself:

“How could such a thing have happened? How could traditions which people do not like or understand, whose effects they usually do not appreciate and can neither see nor foresee, and which they are still ardently combating, continue to have been passed on from generation to generation?” (Hayek 1988, FC, pp. 135-6)

And he admitted that group selection may not be sufficient to establish the “bitter necessity of submitting to rules” (Hayek 1988, FC, p. 76) which man does not like when he tried to address the question which he raised himself above:

“Part of the answer is of course the one with which we began, the evolution of moral orders through group selection: groups that behave in these ways simply survive and increase. But this cannot be the whole story. If not from an understanding of their beneficial effect in creating as-yet unimaginable extended order of cooperation, whence did such rules of conduct originate? More important, how were they preserved against the strong opposition of instinct, and, more recently from the assaults of reason? Here we come to religion” (Hayek 1988, FC, p. 136).

In spite of his overall skepticism toward religion due to its underlying anthropomorphism (a source of rationalist constructivism for Hayek) Hayek (1988, FC, p. 136) must have recourse to religion and superstition: “Custom and tradition, both non-rational adaptations when supported by totem and taboo, or magical or religious beliefs.” Hayek needed an additional (ad hoc) instance (of religion and mysticism) which must secure the general observance of culturally transmitted, learned rules and traditions (appropriate for spontaneous market order) against the genetic instincts (of solidarity and altruism) even when the interrelation between the observance of such

rules and its beneficial effects remains opaque to the individuals and when selection by evolution is not yet fully effective. Hayek (*ibid*, pp. 136-7):

“We owe it partly to mystical and religious beliefs, and, I believe, particularly to the main monotheistic ones, that beneficial traditions have been preserved and transmitted at least long enough to enable those groups following them to grow, and to have the opportunity to spread by natural or cultural selection. This means that, like it or not, we owe the persistence of certain practices, and the civilization that resulted from them, in part to support from beliefs which are not true – or verifiable or testable – in the same sense as are scientific statements, and which are certainly not the result of rational argumentation.”

Thus, in attempting to evade the question of demand on knowledge, of motivation and purposeful action of human beings and to banish rationality (whether utilitarian or otherwise), which might be used to ‘disturb’ spontaneous order, from his theory,²⁰¹ Hayek turned to another extreme position. Hayek (1988, FC, p. 157) even quoted approvingly a passage from *Psyche’s Task* (James Frazer 1909) which reads:

“Superstition rendered a great service to humanity. It supplied multitudes with a motive, a wrong motive it is true, for right action; and surely it is better for the world that men should be right from wrong motives than they would do wrong with the best intentions.”

Doing this, Hayek, however, took the risk of falling into *infinite regression*: The ‘task’ of evolution by group selection is to provide rules and institutions appropriate for the emergence and maintenance of spontaneous order of market and society. If this evolutionary process is to be supported by religious and mystical beliefs, the latter must also imply the same kind of rules and values which sustain the same kind of spontaneous order. This led Hayek (1988, FC, p. 137; italics in the original) to assert that: “*The only religions that have survived are those which support property and the family.*” Regardless of the question whether this is empirically or historically

²⁰¹ See Hayek (1988, FC, p. 137; italics added): “The religious view that morals were determined by processes incomprehensible to us may at any rate be truer (even if not exactly in the way intended) than the rationalist delusion that man, by exercising his intelligence, invented morals that gave him the power to achieve more than he could ever foresee. If we bear these things in mind, we can better understand and appreciate those clerics who are said to become somewhat skeptical of the validity of some of their teachings and who yet continued to teach them because they feared that *a loss of faith would lead to a decline of morals.*”

true, Hayek is here applying his theory of group selection to explain the survival of religions which he invoked to bolster just that theory.

Alchian versus Penrose

That an evolutionary theory can be used in economics to eschew the annoying question of individual incentive and choice is already shown by Alchian (1950 and 1953). Though the context is different from that of Hayek in that Alchian deals with ‘natural selection’ of *firms* whereas Hayek treats cultural evolution of *rules* via group selection, their approach has common characteristics and shares common shortcomings. It is, nonetheless, not quite inappropriate to link Hayek’s evolutionary approach to Alchian because Hayek himself pointed to the latter’s contribution: “Our present understanding of the evolutionary determination of the economic order is in a great measure due to a seminal study of Armen Alchian, ‘Uncertainty, Evolution and Economic Theory’” (Hayek 1979, LLL 3, p. 203, n. 43).

Penrose (1952 and 1953) offers a sharp critique of Alchian’s evolutionary approach.

Alchian admits that in case of incomplete information and uncertain foresight the usual neoclassical assumption of “profit maximization” of individual firms cannot be defined. But neither is it necessary for economic analysis. He contends that by introducing biological analogy the individual behavior of firms can be explained and predicted, which in the end leads to the same result as the standard economic theory. His approach “embodies the principles of biological evolution and natural selection by interpreting the economic system as an adoptive mechanism which chooses among exploratory actions generated by the adaptive pursuit of “success” or “profits”” (Alchian 1950, p. 211). It is based on the notion of “environmental adoption by the economic system of a posteriori most appropriate action according to the criterion of “realized positive profits”” (ibid, p. 211). On what motivation and reasoning individual firms behave, whether they act randomly or adapt themselves to changing environments and consciously try to make profits, is not important since “success is based on results, not motivation”²⁰² (ibid, p. 213). The economic system (“the forest

²⁰² Hayek quoted this statement approvingly in Hayek (1988, FC, p. 118).

of impersonal market forces” in contrast to the trees of “the optimization calculus by individual units”) selects survivors on the criterion of positive profits (in contrast to maximum profits):

“In an economic system the realization of profits is the criterion according to which successful and surviving firms are selected. This decision criterion is applied primarily by an impersonal market system in the United States and may be completely independent of the decision process of individual units, of the variety of inconsistent motives and abilities, and even of the individual’s awareness of the criterion. The reason is simple. Realized positive profits, not maximum profits, are the mark of success and viability. It does not matter through what process of reasoning or motivation such success was achieved. The fact of its accomplishment is sufficient” (ibid, p. 213).

On which circumstances or actions the success depends, whether on the luck or chance (“fortuitous circumstances”) or on the conscious adopting to changing environments is neither important nor known to firms *ex ante*.²⁰³ Even though the firms may not know the conditions of survival or try to achieve them if they do know the conditions, the economist has knowledge of the long-term conditions of survival, which enables him to state “what types of firms or behavior relative to other possible types will be more viable” (ibid, p. 216). Thus, without assuming certainty, foresight and profit-maximizing behavior of firms and without knowing what the individual firms actually do and try the economist can know what characteristics surviving firms would have and predict the effects of changing factors on the firms. With “less restrictive axioms” and more “modest and realistic” approach of evolution and selection than conventional neoclassical approach the economist “still get similar predicted observable circumstances” (Alchian 1953, p. 600)²⁰⁴: “Like the biologist, the

²⁰³ Cf. Alchian (1950, p. 214; italics in the original): “More common types, the survivors, may appear to be those having *adapted* themselves to the environment, whereas the truth may well be that the environment has *adopted* them. There may have been no motivated individual adapting but, instead, only environmental adopting.” This line of argument is quite similar to that of Hayek quoted above: Disliking these constraints so much, we hardly can be said to have selected them; rather, *these constraints selected us: they enabled us to survive*” (Hayek 1988, FC, p. 14; italics added).

²⁰⁴ Cf. Alchian (1953, pp. 600-1): “These less restrictive axioms do not assert that businessmen try to maximize profits, since, with uncertainty, no definite meaning can be attached to that prescription of behavior. It is true that there is some situation, which, if achieved, would, *ex post*, have yielded a larger profit than any other would have. But this situation is unknowable; hence the lack of prescriptive content. But the economist can, from certain generalized production functions and demand functions, infer the directions of changes in the optimal values of the variables of these functions if these values are now to approach the conditions of the new rather than the old optimum. ... The signifi-

economist predicts the effects of environmental changes on the surviving class of living organisms” (Alchian 1950, pp. 220-1).

Milton Friedman (1953) used Alchian’s idea for justifying his “*as if*” argument that assumptions in the economic analysis must not necessarily be true or realistic, that what matters is the capability of predictions following from hypotheses. With respect to firms, independently of what the individual firms really know and actually do, the economist can build the hypothesis that

“under a wide range of circumstances individual firms behave *as if* they were seeking rationally to maximize their expected returns ... and had full knowledge of the data needed to succeed in this attempt; *as if*, that is, they knew the relevant cost and demand functions, calculated marginal cost and marginal revenue from all actions open to them, and pushed each line of action to the point at which the relevant marginal cost and marginal revenue were equal” (Friedman 1953, pp. 21-2).

Although businessmen do neither actually have this knowledge nor solve the system of simultaneous equations, nonetheless the hypothesis of profit maximization (maximization of expected returns in Friedman’s word) is valid for “unless the behavior of businessmen in some way or other approximated behavior consistent with the maximization of returns, it seems unlikely that they would remain in business for long”. Only those firms whose behavior, on whatever basis it might be determined, happens to be consistent with profit maximization, would survive and prosper:

“The process of “natural selection” thus helps to validate the hypothesis – or, rather, given natural selection, acceptance of the hypothesis can be based largely on the judgment that it summarizes appropriately the conditions for survival” (ibid, p. 22).

In assessing three biological analogies (life cycles theory, viability analysis and homeostasis approach) related to the explanation of the firm Penrose made clear some common limitations and shortcomings of such analogies used in economics until 1950s without maintaining that biological analogies *per se* must necessarily be flawed in their use in economics:

cant point is that the new optimum is approached even in the absence of foresighted appropriate adaptive behavior of individual economic units.”

“The characteristic use of biological analogies in economics is to suggest explanations of events that do not depend upon the conscious willed decisions of human beings. This is not, of course, characteristic of biology as such, for some branches of biology are concerned with learning process and decision making, with purposive motivation and conscious choice in men as well as animals. In this, biology overlaps sociology and psychology and, in a sense, even economics. Information drawn from these branches of biology can be useful in helping us to understand the behavior of men and consequently of the institutions men create and operate. In using such information, however, we are not dealing with analogies at all, but with essentially the same problems on a more complex scale. But, paradoxically, where explicit biological analogies crop up in economics they are drawn exclusively from that aspect of biology which deals with *the non-motivated behavior of organisms or in which motivation does not make any difference*” (Penrose 1952, p. 808; italics added).²⁰⁵

As Penrose rightly pointed out, Alchian’s approach shares this characteristic or shortcoming, which attempts

“to provide an explanation of human affairs that does not depend on human motives. The alleged superiority of “viability” over marginal analysis lies in the claim that it is valid even if men do not know what they are doing. No matter what men’s motives are, *the outcome is determined not by the individual participants, but by an environment beyond their control*. Natural selection is substituted for purposive profit-maximizing behavior just as in biology natural selection replaced the concept of special creation of species” (Penrose 1952, p. 812; italics added).

On the one hand, Alchian grants knowledge as to the survival of the firms (that is, how they can make (or at least try to make) as large a profit as possible, or what types of firms or behavior will be more viable) to the economists, which knowledge he disavows to businessmen (Penrose 1952, pp. 812f; Penrose 1953, pp. 607f.). Hence Penrose’s polemical comment: “One can only suggest that firms should hire economists?” (Penrose 1952, p. 813, n. 26)²⁰⁶

²⁰⁵ In a similar vein she argued: “It should be noted that the distinction to be made is not that between human and non-human beings but between actions that are in some degree bound up with and determined by a reasoning and choosing process, no matter how rudimentary, and actions that are, as it were, “built into” the organism, or into the relationship between the organism and its environment, and cannot be altered by conscious decision of the organism itself” (Penrose 1952, p. 818).

²⁰⁶ Cf. Penrose (1953, p. 608): “If the omniscience of the economist extends to the type of firm or of behavior that can survive, it is merely quibbling to insist that he cannot advise as to how that type may be achieved.”

On the other hand, this kind of knowledge is not given even to the economist. Alchian refers to the environment vaguely as an “adoptive mechanism” without giving it a precise meaning. But as Penrose puts it:

“In view of the enormous complexity of the interrelationships in the economy, a prediction of the types of organisms that will survive a given change in the environment involves the prediction of a new general equilibrium and does not seem to be to be an “intellectually more modest and realistic approach” than any other. ... By its very nature a prediction of the kinds of firms that will survive in the long run must take account of all the reactions and interactions that a given change in the environment will induce. With our present knowledge this is impossible ... ” (Penrose 1952, p. 815).

Furthermore, once human motivation and human will are introduced²⁰⁷ the usefulness of Alchian’s model becomes more questionable. Then,

“there is no *a priori* justification for assuming that firms, in their struggle for profits, will not attempt as much consciously to adapt the environment to their own purposes as to adapt themselves to the environment

If firms can deliberate, if they can weigh the relative profitability of assaulting the environment itself and if they can act in ways unknown to the economist, what are the “realized requisites of survival” that can give the economist confidence in his predictions?” (Penrose 1952, pp. 813-4)

It is beyond the scope of my work to judge whether Penrose’s critique of Alchian’s use of biological analogies applies to evolutionary approach *per se* in economics for recently there has been increasing literature on “evolutionary economics”, which is regarded as an alternative to mainstream economics based on the ideas from mechanics and physics and there are now different evolutionary approaches.²⁰⁸ However, her critique holds true for Hayek in spite of formal differences between Alchian’s “biological” evolution and natural selection of firms and Hayek’s cultural evolution

²⁰⁷ Cf. Penrose (1952, pp. 814): “One of the chief characteristics of man that distinguishes him from other creatures is the remarkable range of his ability to alter his environment or to become independent of it.”

²⁰⁸ In operationalizing evolutionary theory in economics Nelson and Winter (1982, pp. 41ff.) seems to have adopted some basic ideas of Alchian to explain growth and decline of firms by their behavior of innovation and imitation. According to Hodgson (1998b, p. 177, n. 9) their approach has, however, affinity with old institutionalism.

of rules and institutions via group selection²⁰⁹ because Hayek subscribed to basic reasoning of Alchian's approach as regards the role of evolution in the construction of economic (and social) theory and in the explanation of real economic (and social) process. Both eschew the question of human deliberation, "free will" and purposive behavior of individuals consciously to adapt to changes in environment and to change the environment itself to their advantage.²¹⁰ System requirements of survival or viability run their course independently of human motivation and deliberate actions. They both invoke evolutionary theory to construct a theory of system viability whose requirements must be accepted and cannot be changed by individuals. Furthermore, as I shall argue below (Ch. 5), similar to Alchian's approach, Hayek shifted the extent of knowledge as to evolutionary process simply to the judge or to the economist.

²⁰⁹ This difference might be of a substantial nature, which Hayek probably did not notice for its consequence would have embarrassed him. The firm belongs to an organization in Hayek's categorization in contrast to an spontaneous order like market etc. If the firm can be subjected to evolutionary process of selection, it cannot be denied that the state or government, a prime case of organization for Hayek, could also be subjected to evolutionary process in theory and in reality. If so, Hayek's contention that the state is a major source of disturbing otherwise favorable working of evolutionary process is untenable. If both spontaneous orders and organizations are objects of social or cultural evolution, it is difficult to see on what criterion we can decide which one interferes with the evolutionary process to which the other is subject to. The question of the relation between Hayekian spontaneous evolution and the state was addressed already by Viner (1961, p. 235): "It seems feasible to me to apply Hayek's method of speculative history to government itself, and to treat it, with all its defects and such merits as Hayek may be willing to concede to it, as itself an institution which is in large degree a spontaneous growth, inherently decentralized, experimental, innovating, subject to not only to tendencies for costly meddling but also to propensities for inertia and costly inaction". Viner reported that in the ancient Greece and Rome there prevailed another view on the government and there was conceptually no strict dichotomy between 'unnatural' government and 'spontaneous' society: "From the time of classical Greece on, there was prevalent the doctrine that government was as 'natural' as the family or as society. Cicero held that government grew or evolved by as 'natural' a process as did customs or mores, and later this was to develop into the doctrine that the growth of government made little more demand on genius and over-all design than did the growth of language. The counter-doctrine that government was a necessary evil, arising out of the fall of man and original sin, and having as its sole reason for existence the disciplining of sinful man, seems to have entered the mainstream of western thought with the advent of Christianity" (Viner 1960, p. 49). Viner (1972, pp. 84f.) later extended validity of his argument to the time before Adam Smith: "To most writers of the period [before the 1750's], as of earlier periods, government, at least after the Fall of Man, was as natural as any other social institution, and its evolution, when discussed at all, was often treated as a phenomenon as spontaneous, as devoid of human central planning, and as receiving as much guidance from providence, as language, or as the development of knowledge in general".

²¹⁰ Forsyth (1988, p. 237) criticized Hayek's liberalism in a similar line: "The most distinctive feature of Hayek's liberalism is that it is not based on the concept of man as essentially a self-determining being, capable by use of his reasoning faculties of conceiving and organizing a form of society in which this freedom is protected and enhanced, but on the quite different ground that man is a natural being; that is to say, a biological organism that differs in degree but not in kind from any other biological organism. Hayek's conception of human society is founded likewise on the analogy between it and a natural order such as a biological organism".

In some instances Hayek himself suggested that it is just what his theory of evolution amounts to:

“The ‘final cause’ or ‘purpose’, i.e., the adaptation of the parts to the requirements of the whole, becomes a necessary part of the explanation of why structures of the kind exist: we are bound to explain the fact that the elements behave in a certain way by the circumstance that this sort of conduct is most likely to preserve the whole – on the preservation of which depends the preservation of the individuals, which would therefore not exist if they did not behave in this manner. A ‘teleological’ explanation is thus entirely in order so long as it does not imply design by a maker but merely the recognition that the kind of structure would not have perpetuated itself if it did not act in a manner likely to produce certain effects, and that it had evolved through those prevailing at each stage who did” (Hayek 1967a, p. 77).²¹¹

In a similar vein Hayek argued later:

“Society can ... exist only if by a process of selection rules have evolved which lead individuals to behave in a manner which makes social life possible. ... for this purpose selection will operate as between societies of different types, that is, be guided by the properties of their respective orders, but that the properties supporting this order will be properties of the individuals, namely their propensity to obey certain rules of conduct on which the order of action of the group as a whole rests” (Hayek 1973, LLL 1, p. 44).

Evolution vs. progress (toward efficiency)

Hayek avoided unequivocally equating evolution with progress, but carefully argued that since “it was the evolution of a tradition which made civilization possible, we may at least say that spontaneous evolution is a necessary if not a sufficient condition of progress” (Hayek 1979, LLL 3, p. 168). It can be understood in this context when Hayek said he had no intention to commit ‘the genetic or naturalistic fallacy’:

“I do not claim that the results of group selection of traditions are necessarily ‘good’ – any more than I claim that other things that have long survived in the course of evolution, such as cockroaches, have moral value” (Hayek 1988, FC, p. 27);

²¹¹ This again shows that in Hayekian framework the free-rider problem does not arise since the structure is by definition not viable where the problem prevails, which also indicates that Hayek is not a methodological individualist: Individuals and society share a common fate.

Or when Hayek said:

“It would be ... be wrong to conclude, strictly from such evolutionary premises, that whatever rules have evolved are always or necessarily conducive to the survival and increase of the populations following them. ... Recognizing that rules generally tend to be selected, via competition, on the basis of their human survival-value certainly does not protect those rules from critical scrutiny” (Hayek 1988, FC, p. 20).

These statements might save Hayek from the critique that his conception of evolution is teleological because it conceives evolution as producing desirable (or efficient) results and as tending toward an ideal state (such as Great Society) and from the critique that Hayekian evolution is Panglossian defending status-quo beyond critical assessment, revision and alteration.²¹² However, in the overall context of his theory of evolution it is difficult to see how it is beyond ‘naturalistic fallacy’; on the contrary, Hayek’s warning against it contradicts his own position. As I will try to show below (Ch. 5), on the one hand he limited the scope of scrutiny and deliberate change or improvement of institutions to the minimum; on the other hand, he has no criterion according to which he can judge desirability and direction of change. More simply, the logic of group selection is susceptible to naturalistic fallacy.

Hayek’s ‘hidden’ teleology,²¹³ in terms of overall evolutionary processes leading to progress is not in line with his denial of any ‘laws of evolution’:

“A belief in selective evolution has ... nothing to do with a belief in laws of evolution. It postulates merely the operation of a mechanism the results of which depend wholly on the unknown marginal conditions in which it operates. I do not believe there are any laws of evolution. Laws make prediction possible, but the effect of the process of selection depends always on unforeseeable circumstances” (Hayek 1979, LLL 3, p. 198, n. 18).

In this case Hayek cannot argue that Great Society can be achieved in a spontaneous-evolutionary manner. There must be some kind of intervention which cannot be,

²¹² For the view that Hayek’s conception of cultural evolution is not Panglossian see Whitman (1998). For a contrary view see Denis (2002).

²¹³ Buchanan and Vanberg (1991, p. 174) level a similar line of critique (of failure to escape “the subliminal teleology of the equilibrium framework”) against Kirzner’s theory of market and entrepreneurship. They also point, in passing, to some ambiguity in Hayek’s concept of competition in this regard.

however, in Hayekian non-rationalistic scheme, substantiated. What Hayek could at most argue is that intervention or deliberate change for the sake of spontaneous orders is not intervention whereas intervention to the ‘disadvantage’ of spontaneous orders (such as market order) is an intervention indeed. Since in Hayekian scheme spontaneous orders are not the result of conscious (or deliberate) efforts of individuals with ex-ante knowledge of benefits accruing from them but the result of appropriate rules and institutions ‘provided’ by selective evolution, individuals cannot consciously aim at an ideal society whose emergence with its characteristics and benefits can only rationally reconstructed in the manner of conjectural history but is not known to individuals. This dilemma can be regarded as stemming from his relying too heavily on evolutionary arguments to make his case for liberal theory and policy; as dilemma between rational reconstruction and real evolutionary process. Hayek must either formulate his evolutionary conception in terms of more explicit teleology which is subject to his own critique of naturalistic fallacy and social Darwinism or he must allow for more room for deliberate change by abandoning his narrow definition of constructivism and liberalism. But Hayek opted in the end for ‘spontaneous-evolutionary’ line of explanation and justification of market order, abandoning his argument for improving institutions and frameworks for markets as he wrote:

“By following the spontaneously generated moral traditions underlying the competitive market order (traditions which do not satisfy the canons or norms of rationality embraced by most socialists), we generate and garner greater knowledge and wealth than could ever be obtained or utilized in a centrally-directed economy whose adherents claim to proceed strictly in accordance with ‘reason’”. ... [Socialists] assume that, since people had been able to *generate* some system of rules coordinating their efforts, they must also be able to *design* an even better and more gratifying system. But if humankind owes its very existence to one particular rule-guided form of conduct of proven effectiveness, it simply does not have the option of choosing another merely for the sake of the apparent pleasantness of its immediately visible effects. The dispute between the market order and socialism is no less than a matter of survival. To follow socialist morality would destroy much of present humankind and impoverish much of the rest” (Hayek 1988, FC, p. 7; italics in the original).

Hayek’s implicit suggestion that evolutionary selection warrants progress is made in various places where he argues that more ‘effective’ institutions²¹⁴ are selected for in

²¹⁴ Hayek took pains to avoid the term ‘efficient’ in this regard.

the evolutionary process: “The present order of society is largely arisen, not by design, but by the prevailing of the more effective institutions in a process of competition” (Hayek 1979, LLL 3, p. 155).

In this regard Leathers (1990) contrasts Veblen’s evolutionary drift with Hayek’s evolutionary teleology:

“Hayek’s ideal situation is the conception of a spontaneous order with its free market economic order. His evolutionism involves a teleological process ending in the emergence of that spontaneous order with its requisite rules, customs, and institutions. Because it is an exercise in conjectural history to explain how that end could have developed, Hayek’s evolutionism fails to provide any explanation of evolutionary change after that point in a manner that is consistent with his preconceptions” (Leathers 1990, p. 174).

Leathers (ibid, p. 176) argues further:

“Hayek’s evolutionary theory is weakened ... by his contention that once the Great Society has evolved spontaneously, institutional evolution ceases to be a process of selection of efficient rules.”

5. Juridical Process and Evolutionary Process of Selection

What Hayek means by ‘positive task of improving institutions’ and relating institutional reform, and how it can be related to his theory of evolution, Hayek did not offer straightforward and concrete answers. His general statements beg more question than answers and are open to different interpretations. Hayek addressed these questions more plainly and vividly in connection with juridical process and the relation between legal reform and legislation. This is, in my view, one important consequence of Hayek’s transformation: interpretation of market economy from the perspective of law and juridical process.

For Hayek development or evolution of law is a case in point for his theory of spontaneous order and evolution as is probably money for Carl Menger. Law, in the sense of lawyer’s law (simply *the* law for Hayek) in contrast with made law or legis-

lation contains, as a spontaneous order, knowledge and experience of many generations and innumerable individuals. The law is, thus, also an example of ‘results of human action and not of human design’, results of trial and error. A most intricate problem in this regard is how to understand Hayek’s explanation of roles of the judge. Whether the judge is within or without the system, whether he is beyond or part of the system.

Hayek and Conservatism

Hayek was aware that his ‘philosophy and economics of liberty’ can be seen as having affinity with and tending toward conservatism, which is not compatible with his self-conception as a liberal. This probably led him to add a postscript entitled “*Why I Am Not a Conservative*” to his *Constitution of Liberty* (Hayek 1960, CL).²¹⁵

Whereas a fear of change, “a timid distrust of the new as such” is one of the fundamental traits of the conservative attitude, “the liberal position is based on courage and confidence, on a preparedness to *let change run its course* even if we cannot predict where it will lead” (Hayek 1960, CL, p. 400; italics added). While the liberals trust “uncontrolled social forces”, “the conservatives are inclined to use the powers of government to prevent change or to limit its rate to whatever appeals to the more timid mind”. Thus, it is not that the liberals consciously endeavor to bring about deliberate changes but that they rely on spontaneous changes, whereas the conservatives take deliberate measures to limit them. For the liberals, deliberate changes in institutions and policy mean removing obstacles for spontaneous, non-deliberate change and paving the way for it:

“Liberalism is not averse to evolution and change; and where spontaneous change has been smothered by government control, it wants a great deal of change of policy. So far as much of current governmental action is concerned, there is in the present world very little reason for the liberal to wish to preserve things as they are. It would seem to the liberal, indeed, that what is most urgently needed in

²¹⁵ See Hayek (1960, CL, p. 397): “Though the position I have tried to define is also often described as “conservative,” it is very different from that to which this name had been traditionally attached. There is danger in the confused condition which brings the defenders of liberty and the true conservatives together in common opposition to developments which threaten their different ideals equally. It is therefore important to distinguish clearly the position taken here [liberalism] from that which has long been known – perhaps more appropriately – as conservatism.”

most parts of the world is a thorough sweeping-away of the obstacles to free growth” (Hayek 1960, CL, p. 399).

That is, the liberals’ belief in change is not that they can influence changes in a way favorable to human beings but that spontaneous forces, if not disturbed (especially by the government), would bring about changes the outcome of which can neither be predicted nor controlled but would be favorable anyhow. This means in the economic field that the liberals believe in the spontaneous market forces whereas the conservatives do not²¹⁶:

“In looking forward, they [the conservatives] lack the faith in the spontaneous forces of adjustment which makes the liberal accept changes without apprehension, even though he does not know how the necessary adaptations will be brought about. It is, indeed, part of the liberal attitude to *assume* that, especially in the economic field, the self-regulating forces of the market will *somehow* bring about the required adjustments to new conditions, although no one can foretell how they will do this in a particular instance. There is perhaps no single factor contributing so much to people’s frequent reluctance to let the market work as their inability to conceive how some necessary balance, between demand and supply, between exports and imports, or the like, will be brought about without deliberate control. The conservatives feels safe and content only if he is assured that some higher wisdom watches and supervises change, only if he knows that some authority is charged with keeping the change “orderly”” (Hayek 1960, CL, p. 400; italics added).

Hayek admitted, however, that there are also some characteristics common to both liberalism and conservatism, that the liberals can learn from “loving and reverential study [by conservative thinkers] of the value of grown institutions [to which] we owe ... some profound insights which are real contributions to our understanding of a free society”. For Hayek, however, conservatives’ belief in spontaneously grown institutions (which include morals, traditions, law, etc.) and in undesigned change is restricted only to the past (Hayek 1960, CL, p. 399f.). The liberals’ position regarding

²¹⁶ Hayek shares this view that the government (with labor unions) is a major destabilizing force in an otherwise stable economy with neoclassicism and monetarism, with which Hayek, however, philosophically and methodologically did not agree. In spite of common political stances there are for example some differences in theory between Hayek on the one hand and Chicago school in general and Milton Friedman in particular on the other hand. As Haberler (1986, p. 422) argues: “Milton Friedman and Friedrich Hayek have much in common; both are staunch supporters of classical liberalism, but as far as money and the business cycle are concerned, they are far apart.” For methodological differences between the Austrian school and the Chicago school in spite of their liberal stance see Paqué (1985).

change, then, boils down to the assertion that we cannot and must not change the course of spontaneous forces, that if we give free rein to them and let them just their course, also *for the future*, they would manage it somehow.

Furthermore, the liberals and the conservatives share a distrust of reason and they do not disdain to “seek assistance from whatever non-rational institutions or habits have proved their worth” (Hayek 1960, CL, p. 406).

As I showed above, Hayek neither conceived of society populated by ‘atomistic’ individuals who are not influenced by socialization and enculturation nor of market order that has no institutional and moral underpinnings. However, he tried to found his explanation and justification of free society and market order on non-rational basis, on spontaneous and evolutionary process beyond human understanding and control. Change is welcomed only insofar as it stems from spontaneous social processes and not from deliberate design.²¹⁷ What individuals can do only is to accept and adapt themselves to changes by obeying conventions and traditions but they can neither deliberately initiate and design changes nor modify the course of spontaneous changes.

Already in 1945 Hayek wrote:

“The individual, in participating in the social processes, must be ready and willing to adjust himself to changes and to submit to conventions which are not the result of intelligent design, whose justification in the particular instance may not be recognizable, and which to him will often appear unintelligible and irrational. ...

Quite as important for the functioning of an individualist society ... are the traditions and conventions which evolve in a free society and which, without being enforceable, establish flexible but normally observed rules that make the behavior of other people predictable in a high degree. The willingness to submit to such rules, not merely so long as one understands the reason for them but so long as one has no definite reasons to the contrary, is an essential condition for the gradual evolution and improvement of rules of social intercourse; and the readiness ordinarily to submit to the products of a social process which nobody has designed and the reasons for which nobody may understand is also an in-

²¹⁷ Hayek’ main concern was to pit the former insight against the latter, which is demonstrated by his dichotomization of major concepts: ‘true’ vs. ‘false’ (rationalistic) individualism; British vs. French tradition of liberalism; evolutionary vs. constructivist rationalism. This tendency began already in 1940s and remained characteristic of his later works including his last book.

dispensable condition if it is to be possible to dispense with compulsion” (Hayek 1945a, p. 22 and p. 23).

Thus, there is no alternative to relying on spontaneous forces, how unaccountable they may be, if we want a free society and avoid coercion:

“Man in a complex society can have no choice but between adjusting himself to what to him must seem the *blind forces of the social process* and obeying the orders of a superior” (Hayek 1945a, p. 24; italics added).

By basing his ‘economics and philosophy of liberty’ on the individuals’ limitation of knowledge, spontaneous orders and evolution to oppose constructivist rationalism that, according to Hayek, attempts to completely and deliberately reshape or redesign society and its legal and moral basis on the grounds of human reason and rationality, Hayek leaned toward conservatism in spite of his assertion to the contrary.²¹⁸ This tendency was strengthened in his later work with increasing importance of his evolutionary arguments, as I tried to demonstrate above.

“The tradition is the product of a process of selection among irrational, or, rather, ‘unjustified’ beliefs which, without anyone’s knowing or intending it, assisted the proliferation of those who followed them (with no necessary relationship to the reasons – as for example religious reasons – for which they were followed). The process of selection that shaped customs and morality could take account of more factual circumstances than individuals could perceive, and in consequence tradition is in some respects superior to, or ‘wiser’ than, human reason” (Hayek 1988, FC, p. 75).

²¹⁸ Criticizing Hayek’s dogmatic classification of individualism into true and false one in Hayek (1945a), Harrod pointed to Hayek’s conservative leaning: “What Professor Hayek seems to be doing here is roughing in a philosophical defense not of individualism, but of the best type of conservatism.” (Harrod 1946, p. 438). For Harrod what Hayek argued against is actually rather radicalism than socialism or collectivism. He said further: “In the eye of truth there is much to be said both for conservatism, a disposition to ascribe hidden values to customs and institutions that have grown up, and for radicalism, the urge to sweep away all the old rubbish. The social value of each disposition depends on time and circumstance. No formula can exempt us from the difficult intellectual task of deciding which way we should incline from time to time, seeking the golden mean, recognizing both the weakness and fallibility of human reason, and also its amazing power” (Harrod 1946, p. 438). Robbins (1961, p. 71) argued in a similar vein: “Professor Hayek’s emphasis on the spontaneous and non-rational origin of important elements in the social order is of quite fundamental importance for the liberal outlook, but that it is liable to become the foundation of an illiberal mysticism rather than “true” liberalism unless it is understood that such elements are subject at all times to critical scrutiny from the standpoint of the requirements of public utility.”

Evolutionary change in the rules

If the ‘task’ of cultural evolution is to select rules appropriate for the emergence and maintenance of spontaneous order of the Great Society and market, there must be variety of rules that stands to selection, which any evolutionary argument requires. If groups or individuals in a group observe only one similar set of rules, there could be no selection of rules via group selection: as Hayek (Hayek 1960, CL, p. 63) put it, “the existence of individuals and groups simultaneously observing partially different rules provides the opportunity for the selection of the more effective ones”.²¹⁹ Since Hayek argued that individuals do not know the (beneficial) effects of observance of rules ex-ante they cannot change or improve them on the expectation of some favorable results. This change or variation is fundamental for Hayek’s argument that cultural evolution is a process of successive replacement of instinctive or innate rules for tribal society (“face-to-face society”) of hunters and gatherers by learnt rules for open or “abstract society”. The transition from the former type of society to the latter is the main content of Hayek’s cultural evolution via group selection. Some members of a group in the *first ‘stage’* must have invented and acted upon new kinds of rules other than then ‘traditional’ rules without knowing what they were doing:

“From that stage²²⁰ practically all advance had to be achieved by infringing or repressing some of the innate rules and replacing them by new ones which made the co-ordination of activities of larger groups possible. Most of these steps in the evolution of culture were made possible by some individuals breaking some traditional rules and practicing new forms of conduct – not because they under-

²¹⁹ This is also Hayek’s rationale for non-coercive, moral rules which require, however, no less than voluntary conformity: “It is this flexibility of voluntary rules which in the field of morals makes gradual evolution and spontaneous growth possible, which allows further experience to lead to modifications and improvements” (Hayek 1960, CL, p. 63). “Gradual and experimental change” is possible in this case: while such rules will be observed by the majority (voluntarily), they can be “broken by individuals who feel that they have strong enough reasons to brave the censure of their fellows” (ibid.). Individuals thus ‘contribute’ to variation of rules, but they neither know nor can determine whether they thereby do service or a disservice to the group to which they belong. That is beyond their knowledge and control for that is the task of evolution.

²²⁰ Hayek’s adoption of the term ‘stage’ is noteworthy particularly because he said: “It would be interesting, but I cannot attempt here, to account for the *succession of the different economic orders* though which civilization has passed in terms of changes in the rules of conduct”. Hayek denied ‘laws of evolution’ which implies “necessary sequences of predetermined stages” and which is equivalent to asserting a “purely mystical necessity that evolution must run a certain predetermined course” as historicism and holistic approach of Comte, Hegel and Marx did (Hayek 1973, LLL 1, pp. 23f.). To what extent and in what respects Hayek’s evolutionism and ‘historicism’, which he found fault with, are really different must be questioned.

stood them to be better, but because the groups which acted on them prospered more than others and grew. We must not be surprised that their rules often took the form of magic or ritual. ... And the law-breakers, who were to be path-breakers, certainly did not introduce new rules because they recognized that they were beneficial to the community, but they simply started some practices advantageous to them which then did prove beneficial to the group in which they prevailed” (Hayek 1979, LLL 3, p. 161).²²¹

Thus, there is no role for ingenuity and intentionality of human beings and no causal mechanism for this essential transition from ‘savagery’ to civilization and market order. It is an incidental result of blind forces of variation and (group) selection. Hayek conjectured only that that process was made possible mostly by relaxations of prohibitions:

“There can be little doubt that from the toleration of bartering with the outsider, the recognition of delimited private property, especially in land, the enforcement of contractual obligations, the competition with fellow craftsmen in the same trade, the variability of initially customary prices, the lending of money, particularly at interest, were all initially infringements of customary rules – so many falls from grace” (Hayek 1979, LLL 3, p. 161).

What is somewhat confusing in this context is the term of tradition which Hayek used: since there are, roughly speaking, two kinds of society with two different kinds of sets of rules in Hayekian scheme, there must be also two kinds of traditions within each society. For Hayek one set of traditional rules must be broken and replaced by another set of traditional rules to which individuals must submit if the Great Society and market order is to be maintained without knowing the effect and function of the rules. There is, thus, no criterion of assessing two kinds of traditions for Hayek other than ‘survival value’ (‘what has survived must be effective’), that is, except that those groups that stuck to the first kind of tradition had not survived and those that

²²¹ Vaughn (1999, p. 138)) might have this line of reasoning in Hayek’s theory of group selection in mind when she argues (without textual references) that “while Hayek’s presentation of his group selection theory admittedly was often murky, it is important to point out that whatever its problems, Hayek was not at all expunging individual agency from his theory of social evolution as some critics have argued. ... Hayek, however, pointed out that it is individual minds that conceive of problems and new ways to solve those problems, and it is individuals who choose whether or not to follow a new rule. Evaluating, choosing individuals are the first step in introducing and selecting any novel course of human action.” My interpretation should show that arguments of ‘some critics’ might be right after all.

‘stumbled upon’ the second kind survived in the selective evolution.²²² ‘New’ rules in the first stage had become traditions in the second stage of cultural evolution.²²³ Cultural evolution is an ongoing process as he himself said (Hayek 1988, FC, p. 74), which implies that there can be no end state. This implies also that we cannot judge an ongoing process from the perspective of an (hypothetical) end state; after all, one important critique of Hayek on the neoclassical concept of equilibrium and competition was its underlying judgment from an ideal or end state of affairs (of equilibrium state with perfect competition). If so, Hayek has no argument whatsoever to exclude the possibility of a ‘third stage of evolution’ for which the second type of traditions must be replaced again by ‘new’ rules via group selection. There is no ex-ante criterion for judging what kind of rules and traditions are more effective or superior other than ex-post assessment on the ground of outcome (of survival) achieved by group selection.²²⁴ So far as Hayek cannot say when group selection has run its course and so far as he means that evolution is an ongoing process, there can be no ‘objective’ and final assessment of rules and ‘traditions’ *as if* from the perspective of the end point where selective process has ceased ‘operating’.²²⁵ It is, therefore, a dilemma for Hayek: without conceiving of Great society with spontaneous market order as an end-state, his evolutionism loses its consistency; but supposing an end-state would contradict his basic arguments regarding market economy and society.

In Hayekian evolutionary scheme the most fundamental transition from savagery and tribal (face-to-face) society to civilization and Great Society was accomplished mainly by blind forces of variation and selection without individuals knowing and intending it. However, Hayek could neither rely on evolutionary process for change in the rules and traditions in Great Society nor justify traditions solely on its survival value. He found the way out in ‘immanent criticism’.

²²² See Hayek (1979, FC, p. 155): “The structures formed by traditional human practices are ... the result of a process of winnowing or sifting, directed by the differential advantages gained by groups from practices adopted for some unknown and perhaps purely accidental reasons.”

²²³ As far as I know, Hayek did not explicitly address the problem of whether for him the second stage epitomized by Great Society amounts to the ‘end of history’.

²²⁴ Only consequently, for Hayek there is no absolute system of morals, hence his claim of ‘moral relativity’ (cf. Hayek 1976, LLL 2, pp. 26-7).

²²⁵ As I showed above (Ch. 1), Hayek leveled this line of critique against the neoclassical notion of perfect competition. Cf. Hayek (1968, p. 182): “It [theory of perfect competition] leaves no room whatever for the *activity* called competition, which is presumed to have already done its task.”

Immanent criticism as ‘the’ way of examining and improving rules

As early as 1961, when Hayek began to develop and formulate evolutionary arguments more in detail and explicitly²²⁶, Robbins (1961, p. 70) indicated intellectual fallacy which may be related to Hayekian arguments:

“While I am largely in agreement with this emphasis on the importance of the non-rational element in social habits and institutions, I confess to a certain fear that, with the less sophisticated, such an emphasis may topple over into indiscriminate acceptance and admiration. After all, not all institutions and habits which survive are to be regarded as beneficial; some at least are unmitigated evils which to treat with respect were absurd. It is certainly not a “rationalist fallacy” to subject them to critical scrutiny.”

Hayek took great pains to show that there is room for critical examination of traditional rules and morals and for institutional and legal reform despite overall theoretical framework of spontaneous order and cultural evolution. He was conscious that his theory could otherwise be seen as ‘merely’ another variant of Panglossian view and can be linked to ‘naturalistic fallacy’ to which Hayek maintained his evolutionism did not amount (see above).

While distinguishing “‘reason properly used’” from the “presumption of reason” he asserted that he does not dispute that “reason may, although with caution and in humility, and in a piecemeal way, be directed to the examination, criticism and rejection of traditional institutions and moral principles” (Hayek 1988, FC, p. 8). He asserted in a similar line:

“It would ... be wrong to conclude, strictly from such evolutionary premises, that whatever rules have evolved are always or necessarily conducive to the survival and increase of the populations following them. We need to show ... how rules that emerge spontaneously tend to promote human survival. Recognizing that rules generally tend to be selected, via competition, on the basis of their human survival-value certainly does not protect those rules from critical scrutiny” (Hayek 1988, FC, p. 20).

Hayek qualified his statement, however, in the directly following sentence in the passage quoted above: “This is so, if for no other reason, because there has so often

²²⁶ Cf. Caldwell (2000 and 2004); Hodgson (1993b and 2004).

been, coercive interference in the process of cultural evolution”, which seems to imply that without interference evolved rules would have matched the survival value to a greater degree.²²⁷

On the basis of the passage quoted above and similar statements of Hayek some authors contended that Hayek did not represent a Panglossian view.²²⁸ But they did not examine what Hayek’s proposals for ‘critical scrutiny’ and piecemeal improvement based on it look like and what they amount to.

According to Hayek, “all criticism of rules must be immanent criticism.”²²⁹

“Since any established system of rules of conduct will be based on experiences which we only partly know, and will serve an order of action in a manner which we only partly understand, we cannot hope to improve it by reconstructing anew the whole of it. If we are to make full use of all the experience which has been transmitted only in the form of traditional rules, all criticism and efforts at improvement of particular rules must proceed within a framework of given values which for the purpose in hand must be accepted as not requiring justification. We shall call ‘immanent criticism’ this sort of criticism that moves within a given system of rules and judges particular rules *in terms of their consistency or compatibility with all other recognized rules in inducing the formation of a certain kind of order of actions*. This is the only basis for a critical examination of moral or legal rules once we recognize the irreducibility of the whole existing system of such rules to known specific effects that it will produce” (Hayek 1976, LLL 2, p. 24; italics added).²³⁰

²²⁷ Hayek (1988, FC, p. 20) made further qualification: “An understanding of cultural evolution will indeed tend to shift the benefit of the doubt to established rules, and to place the burden of proof on those wishing to reform them”.

²²⁸ Cf. Whitman (1998, pp. 47-9); Caldwell (2002, p. 298).

²²⁹ Hayek (1976, LLL 2, p. 28 and p. 43) compared ‘immanent criticism’ to Kantian test of universalizability and Popperian procedure of falsification.

²³⁰ Hayek argued to the same effect earlier in Hayek (1960, CL, p. 63): “At any one stage of our evolution, the system of values into which we are born supplies the ends which our reason must serve. This givenness of the value framework implies that, in our efforts to improve them, we must take for granted much that we do not understand. We must always work inside a framework of both values and institutions which is not of our own making. In particular, we can never synthetically construct a new body of moral rules or make our obedience of the known rules dependent on our comprehension of the implications of this obedience is a given instance.”

This is, however, a rather static view of value systems with which ‘socialized’ or ‘acculturated’ individuals are surrounded, but which they must accept as a whole as given. It is for Hayek important to demonstrate that values and institutions evolved which have proven to be ‘useful’ or ‘effective’; and they have not been designed as a whole for foreseen effects (of usefulness or effectiveness). Values are currently given results of selective evolution or of trial and error which occurred in a previous period. Thus individuals have no knowledge of and influence on what kind of values would be ‘given’ in the next period. It is therefore not at all clear how evolutionary process of selection of value frameworks and improvement of values within a given (hence static) framework can be reconciled; and on what criterion we can judge whether values or institutions were improved within a given value framework if human beings can neither understand nor influence the selection of value frame-

He (Hayek 1976, LLL 2, p. 25; italics added) went on to argue:

“It may at first sight seem puzzling that something that is the product of tradition should be capable of both being the object and the standard of criticism. But we do not maintain that all tradition as such is sacred and exempt from criticism, but merely that the basis of criticism of any one product of tradition must always be other products of tradition which we either cannot or do not want to question; in other words, that particular aspects of a culture can be critically examined only within the context of that culture. We can never reduce a system of rules or all values as a whole to a purposive construction, but must always stop with our criticism at *something that has no better ground for existence than that it is the accepted basis of the particular tradition*. Thus we can always examine a part of the whole only in terms of that whole which we cannot entirely reconstruct and *the greater part of which we must accept unexamined*. As it might also be expressed: we can always only tinker with parts of a given whole but never entirely redesign it.”

With “consistency” Hayek did not, primarily, mean logical consistency but compatibility of a particular rule with the kind of order which the other ‘unquestionable’ rules support:

“The test by which we can judge the appropriateness of a particular rule will always be some other rule which for the purpose in hand we regard as unquestioned. The great body of rules which is in this sense is tacitly accepted determines the aim which the rules being questioned must also support; and this aim ... is not any particular event but the maintenance or restoration of an order of actions which the rules tend to bring about more or less successfully” (Hayek, LLL 2, p. 25).

That means a new (improved) rule must, on the one hand, serve to match the expectations on which different individuals base their plans better than a currently prevailing practice, and, on the other hand, it must also fit the overall order that the established system of rules serves. However, the system of rules which is appropriate for an order (or Great Society in this context) is not adopted on any ex-ante criterion but the ex-post outcome of selective evolution. As the fundamental transition to Great Society is mainly accomplished by evolutionary process of replacing the innate, in-

works. As I argued above, Hayek did not base his theory on the conception of atomistic individual without social or institutional bindings (or in Veblen’s expression (Veblen 1898, p. 73) “a lightening calculator” who has “neither antecedent nor consequent”) but rather on ‘oversocialized’ individuals who have no choice but to obey rules which are not of their own choice but given to them by ‘blind’ forces of evolution, which for Hayek means “reverence for the traditional” (cf. Hayek 1960, CL, p. 63).

instinctive rules by culturally transmitted learnt rules without anybody knowing and intending that effect²³¹, it is difficult to see why within Great Society ‘immanent criticism’ must be possible which requires assessing the effect of a new rule and its compatibility with the other already existing rules which must not be questioned as they serve a “factual order”. Somewhat boldly asked: Why do we need group selection if we have immanent criticism (and vice versa)?

Immanent criticism can be related to his third realm which is epitomized by his conception of spontaneous order which is neither natural nor artificial (as results of human action, but not of human design) or by traditions standing between instinct and reason. It can be understood as Hayek’s answer to the critique of naturalistic fallacy on the one hand and to constructivist (more concretely utilitarian) interpretation of rules conduct. According to Hayek, the latter contends that we can judge the utility of rules on their knowable (or foreseen) effects on concrete ends or purposes, which implies that we can change and reshape the whole system of rules and morals on that rationalistic basis. For Hayek this approach is, thus, based on a “factual assumption of omniscience” (Hayek, LLL 2, pp. 20f.), which is not given in reality. “There would be no need for rules if men knew everything” because we make case-by-case judgment. The only ‘utility’ of rules is, according to Hayek, cannot be a utility known to the acting individuals or to any one person, but only a “*hypostatized ‘utility’*” to society as a whole”, which is equivalent to the “continuous maintenance of an order of actions” (ibid, pp. 22f.; italics added).²³²

²³¹ Hayek put it: “Neither the groups who first practiced these rules, nor those who imitated them, need ever have known why their conduct was more successful than that of others, or helped the group to persist” (Hayek 1976, LLL 2, p. 21).

²³² To what conclusion Hayek’s alternative to constructivist interpretation of rules of conduct leads to and on what questionable basis it is grounded is evidenced by his statement: “The rules of morals are instrumental in the sense that they assist mainly in the achievement of other human values; however, since we only rarely can know what depends on their being followed in the particular instance, *to observe them must be regarded as a value in itself*, a sort of intermediate end which we must pursue without questioning its justification in the particular case” (Hayek 1960, CL, p. 67; italics added). Somewhat boldly remarked: If the observance of rules of morals are to be factually regarded by the individuals as a *value in itself*, Hayek’s theory of cultural evolution would be superfluous. Hayek’s reference to “a value in self” can thus be seen as revealing some insufficiencies of his theory in this regard.

On the other hand, in order to maintain that his theory of spontaneous order and evolution is not susceptible to the critique of naturalistic fallacy, Hayek had to propose a way of critically examining and improving rules and traditions different from that of utilitarian approach.²³³ Immanent criticism is Hayek's attempts to defend his theory on both fronts ('artificial' and 'natural'). Hayek must have conceived it as a 'spontaneous' (and thus 'third') way of examining and improving existing rules (the way of partially 'tinkering with' rules within the given context between the way of wholly redesigning traditional rules and morals on the one hand and the way of wholly accepting them as good on the other). Some problems and inconsistencies of immanent criticism within the context of Hayek's evolutionism is partly discussed above. What kind of demands it actually makes on knowledge can be best illustrated by the role of judge in Hayekian scheme.

Judge as an institution of a spontaneous order

In line with his dichotomy between spontaneous orders and organizations Hayek (1973, LLL 1, pp. 94ff.) distinguished *nomos* (grown law, judge-made law, the lawyer's law, or simply *the law*) from *thesis* (made law, the law of legislation). The former refers to abstract (universal) rules of just conduct which give rise to spontaneous formation of orders; and the latter refers to rules of organization of government.²³⁴ English common law is for Hayek the model of the former.

Rules are for Hayek means of coping with ignorance of human beings as they represent adaptations to circumstances and facts which are not known as a whole to any single mind. The task of the judge is to articulate and improve rules. By their decisions of particular cases he approaches "a system of rules of conduct which is most

²³³ That Hayek is moving on an uncertain terrain with narrow margin can be evidenced by his remark: "It is misleading to represent as utilitarians all authors who account for the existence of certain institutions by their utility, because writers like Aristotle or Cicero, Thomas Aquinas or Mandeville, Adam Smith or Adam Ferguson, when they spoke of utility, appear to have thought of this utility favoring a sort of natural selection of institutions, not determining their deliberate choice by men" (Hayek 1973, LLL 1, p. 155, n. 13).

²³⁴ Hayek (1973, LLL 1, p. 143) warned in this context: "The confounding of the making of rules of just conduct with the direction of the government apparatus tends to produce a progressive transformation of the spontaneous order of society into an organization." See also Hayek (1973, LLL 1, p. 136): "The belief that these instructions to government, because they are also called laws, supersede or modify the general rules applicable to everybody, is the chief danger against which we ought to guard ourselves by clearly distinguishing between the two kinds of 'laws'."

conducive to producing an efficient order of actions” (Hayek 1973, LLL 1, p. 118). In trying to make the whole system of rules more consistent internally, as well as, with the facts to which the rules are applied, the judge makes use of immanent criticism or a process of “piecemeal tinkering”, which is the case in all intellectual evolution (ibid.).²³⁵ This process is a “never-ending one” “since new situations in which the established rules are not adequate will constantly arise” (Hayek, ibid., p. 119).

“The efforts of the judge are thus part of that process of adaptation of society to circumstances by which the spontaneous order grows. He assists in the process of selection by upholding those rules which, like those which have worked well in the past, make it more likely that expectation will match and not conflict. He thus becomes an organ of that order. But even when in the performance of this function he creates new rules, he is not a creator of a new order but a servant endeavoring to maintain and improve the functioning of an existing order. And the outcome of his efforts will be a characteristic instance of those ‘products of human action but not of human design’ in which the experience gained by the experimentation of generations embodies more knowledge than was possessed by anyone” (Hayek, LLL 1, p. 119).

The same question arises as was asked above: if it is the ex-post outcome of evolution that appropriate rules for a spontaneous order such as Great Society and market are selected without any acting individuals intending or understanding it²³⁶, and if thus individuals do not intentionally and wittingly adopt and obey certain rules on the basis of their effects whether on particular purposes or on the survival of the group, how can the judge assess the rules for its compatibility of rules with the viability of the order as a whole on which survival or success of groups depends? Individuals do not know on what the survival of groups depends and from which the benefit of observing given rules derives, but the judge does know according to Hayek. It is even not clear if that is what the judge actually has done or what he *ought to do* if improvement of rules and a given order *is ever to occur* within the context of Hayekian theory of spontaneous order and cultural evolution, as Hayek argues:

²³⁵ Cf. Hayek (1960, CL, p. 35): “The intellectual process is in effect only a process of elaboration, selection, and elimination of ideas already formed.”

²³⁶ Cf. Hayek (1979, LLL 3, p. 157): “Man has certainly more often learnt to do the right thing without comprehending why it was the right thing, and he still is often served better by custom than by understanding”; Hayek (1960, CL, p. 64): “We would destroy the foundations of much successful action if we disdained to rely on ways of doing things evolved by the process of trial and error simply because the reason for their adoption has not been handed down to us. The appropriateness of our conduct is not necessarily dependent on our knowing why it is so.”

“In endeavoring to perform this task he [the judge] will always *have to* move in a given cosmos of rules which he must accept and will *have to* fit into this cosmos a piece *required by the aim which the system as a whole serves*” (Hayek 1973, LLL 1, p. 101; italics added).

Hayek (1973, LLL 1, p. 66; emphasis added) argued to the similar effect:

“In this process the individual lawyer is necessarily more an *unwitting tool*, a link in a chain of events that he does not see as a whole, than a conscious initiator. Whether he acts as a judge or as the drafter of a statute, *the framework of general conceptions into which he must fit his decision is given to him*, and his task is to apply these general principles of the law, not to question them. However much he may be concerned about the future implications of his decisions, he can judge them only in the context of all the other recognized principles of the law that are given to him.”

At the very least it is shifting reason and knowledge of which Hayek deprived individuals to the judge. This is very similar to Alchian’s approach according to which the economist knows the system viability whereas the firms and the entrepreneurs do not (see above). If we examine more closely, even the judge, however, has no knowledge of system viability which serves him as a basis for or criterion of immanent criticism. This knowledge or criterion which is equivalent to the overall understanding of emergence and growth of civilization and free market order (that is theory of spontaneous order and social evolution) is *given* to the judge²³⁷ who ‘merely’ ought to apply this as a principle when proceeding with immanent criticism to ‘improve’ rules with the *given* context.

As I shall show below, in fact, the reasoning is very similar when we consider what Hayek offers as justification of immanent criticism, that is, rational reconstruction or conjectural history.

²³⁷ Leathers’s comparison between the judge in the theory of Hayek and in the theory of Commons in this regard is very pregnant. See Leathers (1989, p. 368 and p. 370): “While Hayek’s judges are concerned only with perfecting an evolved abstract order, Commons’ judges are guided by the public purpose”: “In contrast to Hayek’s impersonal judges, Commons recognized the large influence of habitual assumptions and personalities of individual judges, and hence, of the ‘institutionalized personalities’ of courts.

Rational (mental) Reconstruction as a basis for immanent criticism

‘Piecemeal engineering’ or gradual improvement of rules and thereby given spontaneous order must proceed only on the basis of immanent criticism which requires that new rules (or parts) be fitted into the whole framework of given rules. To assess whether they represent improvement at all on the one hand and whether ‘consistency’ is maintained on the other we need a criterion, which is equivalent to an understanding of how the overall order emerged and can be preserved and principles as to how it should work.

“While our moral traditions cannot be constructed, justified or demonstrated in the way demanded [by constructive rationalism], their processes of formation can be partially *reconstructed*, and in doing so we can to some degree understand the needs that they serve. *To the extent we succeed in this*, we are indeed called upon to improve and revise our moral traditions by remedying recognizable defects by piecemeal improvement based on immanent criticism, that is, by analyzing the compatibility and consistency of their parts, and tinkering with the system accordingly” (Hayek 1988, FC, p. 69; emphasis added).

Hayek argued to the same effect:

“Only a mental reconstruction of the overall order of the Great Society enables us to comprehend that the deliberate aim at concrete common purposes, which to most people still appears as more meritorious and superior to blind obedience to abstract rules, would destroy that larger order in which all human beings count alike” (Hayek 1976, LLL 2, p. 143)

“Freedom will prevail only if it is accepted as a general principle whose application to particular instances requires no justification. . . . *Consistency is possible only if definite principles are accepted*” (Hayek 1973, LLL 1, p. 61; emphasis added).

The ‘overall’ principle to which immanent criticism and piecemeal improvement based on it (ought to) stick can be attained by

“a ‘rational reconstruction’ (using the word ‘construction’ in a sense very different from ‘constructivism’) of how the system might have come into being. This is in effect a historical, even natural-historical, investigation, not an attempt to construct, justify, or demonstrate the system itself. It would

resemble what followers of Hume used to call ‘conjectural history’, which tried to make intelligible why some rules rather than other had prevailed” (Hayek 1988, FC, p. 69).

In the Hayekian framework “rational reconstruction, conjectural history²³⁸, or evolutionary account of the emergence of cultural institutions” amount to the same story (Hayek 1988, FC, p. 70). Thus, we come full circle to Hayek’s theory of spontaneous order and cultural evolution which not only explains how an overall order arises spontaneously by individuals obeying general or uniform rules which are the results of evolutionary selection, but also, being rational reconstruction, serves as a basis for immanent criticism which is the only ‘legitimate’ way of assessing and improving the rules and institutions which are as a whole transmitted to us via evolutionary selection.²³⁹

We can change and improve the order only by influencing the rules. However, the rules must be changed within the context and according to the principle which ought to conform to his *theory* of evolution. This amounts to saying that real evolutionary process *ought to* occur in conformity with the ‘spirit’ of evolution which is set by his theoretical framework²⁴⁰: He can infer desirable course of further evolution from his evolutionary explanation (as *the* theory of social evolution); ‘conjecture’ or ‘rational reconstruction of what might have happened in the past.

Thus seen, it is difficult to understand Hayek’s long-standing harsh critique of historicism or historical school.²⁴¹ The approach of Hayek’s evolutionism and that of historicism are essentially the same, which Hayek could not see or would not admit, apart from one fundamental difference that they point to different courses of further development and suggest different ways of shaping and improving institutions: The

²³⁸ For Hayek’s understanding of conjectural history see Hayek (1979, p. 156; 1988, p. 145). For a critique see Leathers (1990, p. 174f.)

²³⁹ In a somewhat polemical sense, I would argue that Hayek’s theory of order and evolution can be seen in this regard as theory and meta-theory in one.

²⁴⁰ Referring to Michael Rosen (1982), *Hegel’s Dialectic and Its Criticism*, Bellamy argued: “the internal logic of immanent critique is vulnerable to what he [Rosen] calls the ‘post festum paradox’, namely the *paradox of only being able to evaluate the results of immanent critique by depending upon these same results’ validity*. The sole escape from the circularity of this argument is to assume history or social evolution to involve the progressive unfolding of truth. In Hegel’s system this role is played by the concept of *Geist*, but Hayek offers no real grounding for his apparent faith in the cunning of reason” (Bellamy 1994, p. 433: emphasis added).

²⁴¹ Cf. Hayek (1935a, pp. 125ff); Hayek (1952/1979, pp. 111ff); Hayek (1973, p. 24).

one corresponds to the ‘spirit’ of evolution conceived by Hayek, the other does not. Similarity of their approaches can be seen from Hayek’s own assessment of historicism²⁴².

“Historicism ... was a school that claimed to recognize necessary laws of historical development and to be able to derive from such insight knowledge of what institutions were appropriate to the existing situation” (Hayek 1960, CL, p. 236).²⁴³

To make his case more clearly, Hayek again invoked a biological analogy from which he otherwise tried to distinguish his theory of evolution:

“Before we can try to remold society intelligently, we must understand its functioning ... What we must learn to understand is that human civilization has life of its own, that all our efforts to improve things must operate within a *working whole* which we cannot entirely control, and the operation of whose forces we can hope merely to facilitate and assist so far as we understand them. Our attitude ought to be similar to that of the *physician toward a living organism*: like him, we have to deal with a *self-sustaining whole* which is kept going by forces which we cannot replace and which we must therefore use in all we try to achieve. What can be done to improve it must be done by working with these forces rather than against them. In all our endeavor at improvement we must always work inside this given whole, aim at *piecemeal, rather than total, construction*, and use at each state the historical material at hand and improve details step by step rather than attempt to redesign the whole” (Hayek 1960, CL, p. 69; emphasis added).

Evolution of Ideas or Ideas of Evolution

For Hayek ideas or principles (ought to) play a predominant role both in terms of theory and policy.²⁴⁴ This firm belief in the power of ideas²⁴⁵ is for Hayek a ‘trade-mark’ of liberalism:

²⁴² A similar, though passing, comment on Hayek’s evolutionary explanation described in Hayek (1960) was made by Viner (1961, p. 235): “I do not see how this doctrine can be distinguished from “social Darwinism”, or from that “historicism” which Hayek has elsewhere so persuasively warned us against.”

²⁴³ Hayek (1960, CL, p. 236) wrote further: “This view led to an extreme relativism which claimed, not that we are the product of our own time and bound in a large measure by the views and ideas we have inherited, but that we can transcend those limitations and explicitly recognize how our present views are determined by circumstances and use this knowledge to remake our institutions in a manner appropriate to our time. Such a view would naturally lead to a rejection of all rules that cannot be rationally justified or have not been deliberately designed to achieve a specific purpose. In this respect historicism supports ... the main contention of legal positivism.”

“The belief that in the long run it is ideas and therefore the men who give currency to *new ideas that govern evolution*, and the belief that the individual steps in that process should be governed by a *set of coherent conceptions*, have long formed a fundamental part of the liberal creed” (Hayek 1960, CL, p. 112; italics added).

In this regard Hayek spoke of ideology or even of utopia.

He believed in the necessity of an ideology in human society: “every social order rests on an ideology”; “every cultural order can be maintained only by an ideology” (Hayek 1976, p. 54).²⁴⁶ For Hayek ideologies are “sets of principles” and though “admittedly, an ideology is something which cannot be ‘proved’ (or demonstrated to be true), it may well be something whose widespread acceptance is the indispensable condition for most of the particular things we strive for” (Hayek 1973, LLL 1, p. 57 and p. 58).²⁴⁷ For Hayek some ideologies are ‘right’ and coherent and the others ‘wrong’ or contradictory.

His endorsement of the notion of ideology led him to subscribe to that of utopia:

“It is not to be denied that to some extent the *guiding model of the overall order* will always be an utopia, something to which the existing situation will be only a distant approximation and which many people will regard as wholly impractical. Yet it is only by constantly holding up the *guiding conception of an internally consistent model* which could be realized by the consistent application of the same principles, that anything like an effective framework for a functioning spontaneous order will be achieved” (Hayek 1973, LLL 1, p. 64f).

Utopia, an ideal society, does not arise, however, in an evolutionary way. It must, first, be theoretically constructed in a consistent manner, and, second, must be put

²⁴⁴ Hayek put it: “If people were not at most times led by some *system of common ideas*, neither a coherent policy nor even real discussion about particular issues would be possible. It is doubtful whether democracy can work in the long run if the great majority do not have in common at least a *general conception of the type of society desired*” (Hayek 1960, CL, p. 114; emphasis added).

²⁴⁵ This belief in the ideas Hayek (1960, CL, p. 445, n. 14) shared with Keynes who was his lifelong rival even after Keynes’s death.

²⁴⁶ In this respect Douglass North follows in Hayek’s footsteps and defines ideology as “the subjective perceptions (models, theories) all people possess to explain the world around them. Whether at the microlevel of organized ideologies providing integrated explanations of the past and present, such as communism or religions, the *theories* individuals construct are *colored* by normative views of how the world should be organized” (North 1990, p. 23, fn. 7).

²⁴⁷ According to Hayek (1973, LLL 1, p. 58) socialists’ or Marxists’ contempt for ideology stems merely from “the inherent contradictions of their own ideology” and cannot refute the necessity of an ideology as such as a guiding principle.

into practice by ‘reforms’ which can only be guided by rational assessment of alternatives, which cannot be provided by evolution. Hayek did not address this fundamental problem, but merely stated:

“An ideal picture of a society which may not be wholly achievable, or a *guiding conception of the overall order* to be aimed at, is nevertheless not only the indispensable precondition of any *rational policy*, but also the chief contribution that science can make to the solution of the problems of practical policy” (Hayek 1973, LLL 1, p. 65; italics added).

But what is *the* ideology (guiding general principle) by which we approximate *the* utopia, Hayekian utopia of Great Society with free market order? His theory of spontaneous order and evolution delivers not only ideology and utopia but also the way of how we can achieve it: namely that of acting in accordance with his theory.

“Liberalism thus derives from the discovery of a self-generating or spontaneous order in social affairs (the same discovery which led to the recognition that there existed an object for theoretical social sciences), an order which made it possible to utilize the knowledge and skill of all members of society to a much greater extent than would be possible in any order created by central direction, and the consequent desire to make as full use of these powerful spontaneous ordering forces as possible” (Hayek 1966a, p. 162).

On the one hand, evolution cannot be guided which is beyond individuals’ understanding and control:

“to pretend to know the desirable direction of progress seems to me to be extreme of hubris. Guided progress would not be progress. But civilization has fortunately outstripped the possibility of collective control, otherwise we would probably smother it” (Hayek 1979, LLL 3, p. 169).

“To confine evolution what we can foresee would be to stop progress; and it is due to the favorable framework which is provided by a free market ... that the new which is better has a chance to emerge” (Hayek 1979, LLL 3, p. 169).

On the other hand, evolution must be guided by ‘right’ ideas or principles, if the overall order of Great Society is to be preserved and improved, and not to deteriorate or to collapse.

“From the insight that the benefits of civilization rest on the use of more knowledge than can be used in any deliberately concerted effort, it follows that it is not in our power to build a desirable society by simply putting together the particular elements that by themselves appear desirable. Although probably all beneficial improvement must be piecemeal, if the separate steps are not guided by a *body of coherent principles*, the outcome is likely to be a suppression of individual freedom” (Hayek 1973, LLL 1, p. 56; emphasis added).

“An experiment can tell us only whether any innovation does or does not fit into a given framework. But to hope that we can build a coherent order by random experimentation with particular solutions of individual problems and without following guiding principles is an illusion. Experience tells us much about the effectiveness of different social and economic systems as a whole. But an order of the complexity of modern society can be designed neither as a whole, nor by shaping each part separately without regard to the rest, but only by *consistently adhering to certain principles throughout a process of evolution*” (Hayek 1973, LLL 1, p. 60; emphasis added).

The question of from where Hayekian ideology or Utopia (or guiding model of the overall order; guiding conception of an internally consistent model; a body of coherent principles) comes, Hayek did not deal with explicitly. In so far as Hayek argued that there is a guiding conception of the overall order and that there is a coherent body of principles to be consistently adhered to throughout the process of evolution, this model or principle are themselves not the product of nor subject to evolutionary selection process. Since in Hayekian evolutionism rules and even morals appropriate for Great Society are ‘provided’ by evolutionary selection, Hayek must have explained why ideas and principles must lie beyond the grasp of evolution, serving as guideline of evolution.²⁴⁸ This is a serious dilemma for Hayek. For if he made ideas and principles also susceptible to evolutionary selection process he would loose all ground on which he could criticize any real deviation from his ideal. On the other hand, he, then, must have explained on what other process or criterion (than survival or prosperity of a group) he might claim emergence of and superiority or rightness of ideas or principles espoused by him which must guide the social evolution as a kind of ‘*meta-theory*’ of evolution, which he did not deliver.²⁴⁹

²⁴⁸ Hodgson’s critique of Hayek’s theory of evolutionary selection, though made in a different context, can be seen as pointing to a similar direction: “If the market is the *context* of selection then the origin of this framework is itself unexplained. If the market is an *object* of selection then for its selection to be real it must exist alongside other non-market forms” (Hodgson 1993c, p. 177).

²⁴⁹ For a similar line of critique see Nafissi (2000).

While Hayek (1973, LLL 1, p. 70) once more argued that

“There are few things which must impress themselves more strongly on the student of the evolution of social institutions than the fact that what decisively determines them are not good or bad intentions concerning their immediate consequences, but the general preconceptions in terms of which particular issues are decided.”

To the prevalence of ideas or principles he (Hayek, *ibid.*) offered only, if at all, an evasive answer:

“Which ideas will dominate, mostly without people ever being aware of them, is, of course, determined by a slow and immensely intricate process which we can rarely reconstruct in outline even in retrospect.”

6. Hayek’s Critique of Social Justice

The significance of Hayek’s twin ideas of spontaneous order and cultural evolution for his position of social philosophy and his policy stance is most clearly revealed in his critique of social justice. In spite of this close relation between the two, this connection was not clearly seen and dealt with by those who in some other aspects critical of Hayek’s theory of spontaneous order and evolution to a different degree (cf. Buchanan 1977 and 1986; Vanberg 1983).²⁵⁰

According to Hayek social justice cannot be defined in an spontaneous order like a market order.²⁵¹ It is, nonetheless, harmful because any attempt to realize social justice in a market order and free society would lead to its transformation into socialism and/or totalitarian regime. ‘Social justice’ has been his target of criticism from his earlier work on since “it plays such an important part in arguments for and against socialism” (Hayek 1988, FC, p. 117). For Hayek modern socialism cannot be de-

²⁵⁰ This shows that the question of whether Hayek’s theory is compatible with and lends support to change rules at the constitutional level or not, which is a main concern of constitutional economists with respect to Hayek, is not necessarily related to the question of whether institutional reform for social melioration is possible in Hayekian scheme.

²⁵¹ Since for Hayek the term ‘social justice’ is “entirely empty and meaningless” just as “the Emperor has no clothes on”, he found nothing that he could positively demonstrate and saw his task in “putting the burden of proof squarely those who employ the term” (Hayek 1976, LLL 2, xi-xii).

financed by its method of collective ownership and central economic planning any more but by its aims of an egalitarian or more just distribution.²⁵² Thus, social justice has come to be just another name for socialism and can only be understood as distributive justice. If the welfare state, the conception of which has no precise meaning for Hayek, goes beyond the concept of “limited security”²⁵³ (“the assurance of a given minimum of sustenance for all” or “the security of an equal minimum income for all”) to the concept of “absolute security” (“the assurance of a given standard of life” or “the security of a particular income that a person is thought to deserve”) and even to the related third concept of a more just distribution of incomes by using coercive powers of government, it is “bound to lead back to socialism and its coercive and essentially arbitrary methods” (Hayek 1960, CL, pp. 259f.).²⁵⁴ For Hayek a free society can only be based on commutative justice, and distributive justice is not

²⁵² Hayek (1960, CL, p. 254) wrote: “Socialism in the old definite sense is now dead in the Western world. ... If, fifteen years ago, doctrinaire socialism appeared as the main danger to liberty, today it would be tilting at windmills to direct one’s argument against it.”

²⁵³ Although Hayek (1960, CL, p. 257) argued that “it can hardly be denied that, as we grow richer, that minimum of sustenance which the community has provided for those not able to look after themselves, and which can be provided outside the market”, Hayek gave neither clear justification for the assurance of minimum of assurance nor clarification of what he meant by “outside the market”. Later he argued in a similar vein: “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 To enter into such an assurance against extreme misfortune may well be in the interest of all; or it may be felt to be a *clear moral duty* of all to assist, within the organized community, those who cannot help themselves. So long as such a uniform minimum income is provided *outside the market* to all those who, for any reason, are unable to earn in the market an adequate maintenance, this need not lead to a restriction of freedom, or conflict with the Rule of Law” (Hayek 1976, LLL 2, p. 87; italics added). For ambiguities and inconsistencies in Hayek’s explanation of and justification for assurance of minimum sustenance see Guest (1997, pp. 60f.).

The point is not that Hayek must be criticized for endorsing some form and amount of ‘welfare measures’, which he suggested clearly in Hayek (1960, CL, pp. 253ff.) but that they can not easily be reconciled with his overall framework. In his review of Hayek (1960, CL), Viner (1961, pp. 235f.) already clearly pointed this out: “I am not at all satisfied that he has shown that his program has any practical possibilities of realization consistent with the principles of “rule of law,” of “equality before the law,” and of “freedom from coercion” as he expounds them in the earlier portions of his book. His support for the program is largely in terms of “There is no reason why not” or “there is little reason why not” and there is scanty, perhaps no, indication of the nature of thinking which led Hayek to give support to a program which, with all its limitations and qualifications, does involve a measure of redistribution of income through government “coercion”.”

²⁵⁴ See also Hayek (1960, CL, pp. 256f.): “Many of the old socialists have discovered that we have already drifted so far in the direction of a redistributive state that it now appears much easier to push further in that direction than to press for the somewhat discredited socialization of the means of production. They seem to have recognized that by increasing governmental control of what nominally remains private industry, they can more easily achieve that redistribution of incomes that had been the real aim of the more spectacular policy of expropriation.”

compatible with a free society.²⁵⁵ Social justice can be achieved where a central authority determines a unified scale of importance of different things, has knowledge of differences of knowledge and talent of different individuals and has power to assign to them tasks to be performed (Hayek 1976, LLL 2, pp. 81ff).²⁵⁶ Therefore social justice is not compatible with freedom and market economy which, as impersonal mechanism, brought about deprivation of arbitrary power.

“In fact, that systematic pursuit of the *ignis fatuus* of ‘social justice’ which we call socialism is based throughout on the atrocious idea that political power ought to determine the material position of the different individuals and groups – an idea defended by the false assertion that this must always be so and socialism merely wishes to transfer this power from the privileged to the most numerous class. It was the great merit of the market order as it has spread during the last two centuries that it deprived everyone of such power which can be used only in arbitrary fashion. It has indeed brought about the greatest reduction of arbitrary power ever achieved. This greatest triumph of personal freedom the seduction of ‘social justice’ threatens again to take from us” (Hayek 1976, LLL 2, p. 99).

There are several arguments of Hayek against social or distributive justice.

Firstly, social justice is against the Rule of Law, which implies universal application of general rules or equal treatment of all the people before the law, which is also essence of justice for Hayek. Already in 1944 Hayek stated:

“Formal equality before the law is in conflict, and in fact incompatible, with any activity of the government deliberately aiming at material or substantive equality of different people, and that *any policy aiming directly at a substantive ideal of distributive justice must lead to destruction of the Rule of Law*. To produce the same result for different people, it is necessary to treat them differently. To give different people the same objective opportunities is not to give them the same subjective chance. It cannot be denied that the Rule of Law produces economic inequality – all that can be claimed for it is that this inequality is not designed to affect particular people in a particular way” (Hayek 1944/1994, RS, pp. 87-8; italics added).

²⁵⁵ Cf. Hayek (1976, LLL 2, p. 86): “The distributive justice at which socialism aims is ... irreconcilable with the rule of law, and with that freedom under the law which the rule of law is intended to secure.”

²⁵⁶ See Hayek (1976, LLL 2, p. 85): “The idea that men ought to be rewarded in accordance with the assessed merits or deserts of their services ‘to society’ presupposes an authority which not only distributes these rewards but also assigns to the individuals the tasks for the performance of which they will be rewarded. In other words, if ‘social justice’ is to be brought about, the individuals must be required to obey not merely general rules but specific demands directed to them only.”

In a similar vein, Hayek pitted freedom and justice against economic equality in 1960:

“From the fact that people are very different it follows that, if we treat them equally, the result must be inequality in their actual position, and that the only way to place them in an equal position would be to treat them differently. *Equality before the law and material equality are therefore not only different but are in conflict with each other*; and we can achieve either the one or the other, but not both at the same time. The equality before the law which freedom requires leads to material inequality. ... though where the state must use coercion for other reasons, it should treat all people alike, the desire of making people more alike in their condition cannot be accepted in a free society as a justification for further and discriminatory coercion²⁵⁷” (Hayek 1960, CL, p. 87; italics added).²⁵⁸

Equality of all before the law leads, thus, inevitably to economic inequality, which must be accepted in a free society based on market order. Underlying this attitude is also the view that economic inequality not simply a necessary price paid for the benefits of civilization which can be maintained and developed only by market framework, but, furthermore that it contributes to economic progress as well: “The rapid economic advance that we have come to expect seems in a large measure to be the result of this inequality and to be impossible without it” (Hayek 1960, CL, p. 42).²⁵⁹

²⁵⁷ See also Hayek (1976, LLL 2, p. 83): “While an equality of rights under a limited government is possible and an essential condition of individual freedom, a claim for equality of material position can be met only by a government with totalitarian powers”; Hayek (ibid, p. 181, n. 30): “Material equality and liberty are irreconcilable”.

²⁵⁸ Compare also Hayek’s similar arguments: Hayek (1960, CL, p. 99): “Insofar as we want the efforts of individuals to be guided by their own views about prospects and chances, the results of the individual’s effort are necessarily unpredictable, and the question as to *whether the resulting distribution of incomes is just has no meaning*. Justice does require that those conditions of people’s lives that are determined by government be provided equally for all. But equality of those conditions must lead to inequality of results”; Hayek (1976, LLL 2, p. 82): “Since people will differ in many attributes which government cannot alter, to secure for them the same material position would require that government treat them very differently. Indeed, to assure the same material position to people who differ greatly in strength, intelligence, skill, knowledge and perseverance as well as in their physical and social environment, government would clearly have to treat them very differently to compensate for those disadvantages and deficiencies it could not directly alter. Strict equality of those benefits which government could provide for all, on the other hand, would clearly lead to inequality of the material positions.”

²⁵⁹ In a quite elitist-aristocratic manner Hayek (1960, CL, p. 44) claims: “The path of advance is greatly eased by the fact that it has been trodden before. It is because scouts have found the goal that the road can be built for the less lucky or less energetic. What today may seem extravagance or even waste, because it is enjoyed by the few and even undreamed of by the masses, is payment for the experimentation with a style of living that will eventually be available to many. The range of what will be tried and later developed, the fund of experience that will become available to all, is greatly ex-

Violation of Rule of Law or equal application of general rules to all is also one of his main arguments²⁶⁰ against redistribution by progressive taxation²⁶¹ which is for Hayek “the crucial issue on which the whole character of future society will depend” (Hayek 1960, CL, p. 306):

“It is the great merit of proportional taxation that it provides a rule which is likely to be agreed upon by those who will pay absolutely more and those who will pay absolutely less and which, once accepted, raises no problem of a separate rule applying only to a minority. ... In no sense can a progressive scale of taxation be regarded as a general rule applicable equally to all – in no sense can it be said that a tax of 20 per cent on one person’s income and a tax of 75 per cent on the larger income of another person are equal. Progression provides no criterion whatever of what is and what is not to be regarded as just” (Hayek 1960, CL, pp. 314-5).

Lacking any guidance by a general rule or a uniform principle²⁶², progressive taxation is “an invitation to majority to discriminate against a minority”; “the pretext for pure arbitrariness”; and “an attempt to impose upon society a pattern of distribution determined by majority decision” (Hayek 1960, CL, pp. 311ff).

For Hayek, progressive taxation is “the chief means of redistributing incomes”. As Hayek opposes measures aiming at ‘distributive justice’ as violation of rule of law and incompatible with a free society, his critique of progressive taxation is only consequent.

Social Justice and Spontaneous Order

Secondly, social justice is meaningless in a spontaneous order. For Hayek justice can be applied to human conducts and related rules, not to results or circumstances beyond their control:

tended by the unequal distribution of present benefits ... Even the poorest today owe their relative material well-being to the results of past inequality.”

²⁶⁰ For another arguments of Hayek against progressive taxation see Hayek (1960, CL, pp. 316-323

²⁶¹ What Hayek takes issues with is the progression of taxation as a whole due mainly to progressive income tax; for Hayek a slight progression of income tax is acceptable, however, to compensate for proportionally heavier burden of indirect taxes on the smaller incomes (Hayek 1960, CL, p. 307).

²⁶² See Hayek (1960, CL, p. 313): “Unlike proportionality, progression provides no principle which tells us what the relative burden of different persons ought to be. It is no more than a rejection of proportionality in favor of a discrimination against the wealthy without any criterion for limiting the extent of this discrimination.”

“Strictly speaking, only human conduct can be called just or unjust. If we apply the terms to a state of affairs, they have meaning only in so far as we hold someone responsible for bringing it about or allowing it to come about. A bare fact, or a state of affairs which nobody can change, may be good or bad, but not just or unjust. To apply the term ‘just’ to circumstances other than human actions or the rules governing them is a category mistake” (Hayek 1976, LLL 2, p. 31).

“Nature can be neither just nor unjust. Though our inveterate habit of interpreting the physical world animistically or anthropomorphically often leads us to such a misuse of words, and makes us seek a responsible agent for all that concerns us, unless we believe that somebody could and should have arranged things differently, it is meaningless to describe a factual situation as just or unjust. But nothing that is not subject to human control can be just (or moral), the desire to make something capable of being just is not necessarily a valid argument for our making it subject to human control; because to do so may itself be unjust or immoral, at least when the actions of another human being are concerned” (Hayek 1976, LLL 2, p. 32).

Spontaneous orders arise as unintended consequences of human interactions, that is result of human action and not of human design. The effects of market order as a major case of spontaneous order for Hayek cannot be judged as just or unjust because it is an impersonal mechanism beyond anyone’s will or control²⁶³:

“It has of course to be admitted that the manner in which the benefits and burdens are apportioned by the market mechanism would in many instances have to be regarded as very unjust *if* it were the result of a deliberate allocation to particular people. But this is not the case. Those shares are the outcome of a process the effect of which on particular people was neither intended nor foreseen by anyone when the institutions first appeared – institutions which were then permitted to continue because it was found that they improve for all or most the prospects of having their needs satisfied. To demand justice from such a process is clearly absurd, and to single out some people in such a society as entitled to a particular share evidently unjust” (Hayek 1976, LLL 2, pp. 64-5).

No individual and no voluntary cooperation of individuals can be made responsible for the outcomes of the impersonal mechanism of market order. For in a Great Soci-

²⁶³ Gordon (1981, p. 483) remarks scathingly on this point: “If it is meaningless to apply the conduct of justice to the market order, then the market order is neither just nor unjust. But the practical import, as far as policy is concerned, is that the distribution generated by the market must be accepted, which is equivalent to regarding it as just. Even if Hayekians were scrupulously careful in their language, one would have reason to suspect that what they really contend is not that ‘social justice’ is a ‘mirage,’ but that it is in fact realized in a system of competitive markets.” This kind of reasoning (of Hayekians) delivers justification for the argument that market economy is inherently social and that social market economy must be understood in this perspective, which has, however, not much to do with Müller-Armack’s theory of Social Market Economy, but which is nearly the opposite of the latter.

ety of free men in which each is allowed to use his knowledge for his own purposes nobody can predict or even determine the relative incomes of the different people. Therefore, ‘social justice’ can be given a meaning only in a directed or ‘command’ economy (an organization according to Hayekian category) in which the individuals are ordered what to do:

“It presupposes that people are guided by specific directions and not by rules of just individual conduct. Indeed, no system of rules of just individual conduct, and therefore no free action of the individuals, could produce results satisfying any principle of distributive justice” (Hayek 1976, p. 69).

Thus, the demand of social justice on the market order stems from misunderstanding of its functioning. Furthermore, attempts to achieve social justice, which is for Hayek *per definitionem* impossible in spontaneous market order, could only lead to undermine the free society²⁶⁴ and the market process in the end:

“The fruitless attempt to *render a situation just* whose outcome, by its nature, cannot be determined by what anyone does or can know, only damages the functioning of the process itself” (Hayek 1988, FC, p. 74; italics in the original).

For Hayek justice can only mean commutative justice.²⁶⁵ In this context just prices are for Hayek prices determined by the market mechanism, which, he maintained, corresponds to the medieval (scholastic) conception of the just price.²⁶⁶

“Justice in this connection can mean only such wages or prices as have been determined in a free market without deception, fraud or violence; and that, in this one sense in which we can talk about meaningfully about just wages or just prices, the result of a wholly just transaction may indeed be that one side gets very little out of it and the other a great deal” (Hayek 1973, LLL 1, p. 141).²⁶⁷

²⁶⁴ Hayek (1976, LLL 2, p. 136; italics added) even went so far as to assert that “it is indeed the concept of ‘social justice’ which has been the *Trojan Horse* through which totalitarianism has entered.”

²⁶⁵ Cf. Hayek (1973, LLL 1, p. 141): “Justice is not concerned with the results of the various transactions but only with whether the transactions themselves are fair.”

²⁶⁶ Hayek (1976, LLL 2, p. 73) argued that what the late schoolmen recognized was that “the prices determined by just conduct of the parties in the market, i.e. the competitive prices arrived at without fraud, monopoly and violence, was all that justice required.”

²⁶⁷ It is interesting to compare Hayek’s view to the *critique of laissez-faire* made by Cairnes in 1870: “I think the prevailing notion is that it [Political Economy] undertakes to show that wealth may be most rapidly accumulated and most fairly distributed – that is to say, that human well-being may be most effectually promoted – by the simple process of leaving people to themselves; leaving individu-

And Hayek (ibid.) added:

“Classical liberalism rested on the belief that there existed discoverable principles of just conduct of universal applicability which could be recognized as just irrespective of the effects of their application on particular groups.”

There have been, however, ongoing discussions over the interpretation of the notion of just price which originates with Aristotle and Aquinas. Hayek’s view in this regard can be supported by De Roover (1951 and 1958) who argues that

“according to the majority of the doctors, the just price did not correspond to cost of production as determined by the producer’s social justice, but was simply the *current market price*, with this important reservation: in cases of collusion or emergency, the public authorities retained the right to interfere and to impose a fair price”²⁶⁸ (De Roover 1958, pp. 420-1; emphasis added)²⁶⁹;

and that “beyond doubt ... he [Aquinas] considered the market price as just” (De Roover 1958, p. 422).

In contrast, Wilson (1975) argues that “Aquinas’ theory of justice in exchange involves prices which cover the “costs” of production where these are weighted by the social estimate of the “worth” of the laborer in a particular class” (Wilson 1975, p. 68-9). The notion of the just price was “a social and prescriptive device that attempted to have the needed goods and services produced and distributed in accordance with *prevailing views of equity*” (ibid, p. 73; italics added). Although it was developed under the (ancient and medieval) economic conditions of “low-level

als, that is to say, to follow the promptings of self-interest unrestrained either by the State or by public opinion, so long as they abstain from *force and fraud*. This is the doctrine commonly known as *laissez-faire*; and, accordingly, Political Economy is, I think, very generally regarded as a sort of scientific rendering of this maxim, - a vindication of freedom of industrial enterprise and of contract, as the one and sufficient solution of all industrial problems” (Cairnes 1873, p. 241).

²⁶⁸ In other place, De Roover (1951, p. 496; emphasis added) made similar formulations but somewhat more clearly: “[I]t seems clear to me that the just price was nothing more mysterious than *the competitive price*, with this important qualification: the Doctors never questioned the right of the public authorities to set and regulate prices. In the absence of regulation, however, the just price was the one set by common estimation, that is by the free valuation of buyers and sellers, or, in other words, by *the interplay of the forces of demand and supply*.”

²⁶⁹ With his interpretation of the just price De Roover (1958, p. 418) criticizes “a widespread belief” that “the just price, instead of being set by the allegedly blind and unconscionable forces of the market, was determined by criteria of fairness without regard to the elements of supply and demand or at least with the purpose of eliminating the evils of unrestrained competition.”

chronic conditions” (ibid, p. 62), Wilson suggests that it is relevant for modern economy:

“The market mechanism is a highly efficient way to organize productive activity, but it is clear that we need to go well beyond the market to ensure justice in the distribution of income. Although our definition of justice differs sharply from that of the Middle Ages, we can still accept the aim of a society where ... men stand united by that they do – not divided by what they have” (Wilson 1975, p. 73).²⁷⁰

Ramstad (2001, p. 274) follows this line of interpretation of the just price and points to “some interesting parallels between medieval “economics” and Commons’s analytical standpoints” and goes so far as to propose that “John R. Commons’s Theory of Reasonable Value should be categorized as a secularized, twentieth-century renewal of the quest for an economics of the Just Price” and argues that:

“Commons, as did the founder of the Just Price economics more than seven centuries ago, considered the issue of economic justice through institutional adjustment to be the central challenge of economic policy *and hence of economic theory*” (ibid; italics in the original).²⁷¹

In criticizing exclusive focus of free-market theorists on the commutative justice (concerning “just relations in economic transactions between pairs of individuals) while ignoring or excluding distributive justice (concerning “intervention of state authority directly or indirectly with the intention of changing an existing pattern of distribution of this world’s goods”), Viner (1960, p. 68) argued:

“No modern people will have zeal for the free market unless it operates in a setting of “distributive justice” with which they are tolerably content. ... a laissez faire program which confined its efforts to preserving or restoring a free market, even a competitive market, while remaining silent on or opposing any proposals for adopting new or retaining old measures in the area of distributive justice, would seem to me glaringly unrealistic with respect to its chances of political success, and highly unquestionable also with respect to more exalted criteria of merit.”

²⁷⁰ Wilson (1975, p. 74) argues further: “the view that what is justice in exchange depends upon a society’s goals and the refusal or inability to rely upon even competitive market forces as determining just exchange ratios may be something worth reiterating as the world’s economies grope towards the twin goals of rapid growth *and* greater social and economic justice.”

²⁷¹ For more on the controversy over the interpretation of the just price see Friedman (1980); Hollander (1965); Worland (1977).

Furthermore, Viner called into question whether the two issues can be analytically separated and distributive justice cannot be attained:

“When economists discuss the workings of a free competitive market, they agree that the existing pattern of distribution of wealth, of income, and of individual knowledge, capacities, and skills, affects the price-structure. They presumably agree also that the price-structure of today affects the income-structure of tomorrow. It is not appropriate, therefore, in a final appraisal from either an ethical or an economic-efficiency point of view of the mode of operation of an economic system, to consider the operations of the market on the assumption that the existing pattern of income distribution in the consequence of a dispensation of Providence. It is not reasonable to treat an existing income distribution, for the purpose of analyzing the market, *as if it just “happened,”* as if it were as independent of influence by the market and as incapable of influence on the market, through the effect of aggregate human exercises of will and economic power, as the Rocky Mountains or storms and earthquakes are free from human control” (Viner 1960, p. 67; italics added).²⁷²

It is interesting to note that Irving Kristol, a Conservative, points to problems regarding Hayek’s way of justifying capitalism, that of “opposing a *free* society to a *just* society”:

“But can men live in a free society if they have no reason to believe it is also a just society? ... men cannot accept the historical accidents of the marketplace – seen merely as accidents – as the basis for an enduring and legitimate entitlement to power, privilege, and property. And, in actual fact, Professor Hayek’s rationale for modern capitalism is never used outside a small academic enclave.” (Kristol 1971, p. 8 and p. 9).²⁷³

²⁷² Sufrin (1961, p. 204) argues to a similar effect: “Economic progress ... is itself qualitative. The nature, the mix, and the distribution of economic goods are of political and moral significance in any society. Determination of such considerations probably cannot rely directly entirely on the working of the free market. To assert that market (impersonal) decisions are always better than conscious (political) ones is to assert that somehow the automatic, mechanical operations of a market are morally and technically superior to the exercise of freedom via politics. ... That economic markets are impersonal, have the appearance of tidiness, and hence are easier for some to live with than the messiness bred of compromise which marks the political market place is, I think, one of the reasons why the market is so appealing. ... But to assert that freedom in the political arena is on a lower or less good level than market freedom requires more than an economic analysis, for the values and considerations are not “given” by assumption.”

²⁷³ With reference to Kristol (1971), Hayek (1976, LLL 2, p. 73) contended, however that: “It has been argued persuasively that people will tolerate major inequalities of the material positions only if they believe that the different individuals get on the whole what they deserve, that they did in fact support the market order only because (and so long as) they thought that the differences of remuneration corresponded roughly to differences of merit, and that in consequence the maintenance of a free society presupposes the belief that some sort of ‘social justice’ is being done. The market order, however, does not in fact owe its origin to such beliefs, nor was originally justified in this manner.”

Social Justice and Cultural Evolution

Perhaps the most controversial issue regarding Hayek's theory of cultural evolution is its relation to his critique of social justice, that is, Hayek's view of social justice as "atavism" (Hayek 1976/1978; Hayek 1979, LLL 3, pp. 165f;); as "revival of primordial instincts" (Hayek 1979, LLL 3, p. 169); as "recidivism to the morals of the primitive micro-order" (Hayek 1988, FC, p. 75). Hayek's main contention in this regard is that:

"They [the ideals of socialism or of social justice] are an atavism, a vain attempt to impose upon the Open Society the morals of the tribal society which, if it prevails, must not only destroy the Great Society but would also greatly threaten the survival of the large numbers to which some three hundred years of a market order have enabled mankind to grow" (Hayek, LLL 2, p. 147).²⁷⁴

The relation between cultural evolution and social justice in Hayek's work is manifold or multi-layered. On the one hand, with his theory of cultural evolution Hayek tried once more to make clear that social justice is not appropriate for the market order, the basis of civilization and free society for Hayek. On the other hand, with his critique of social justice Hayek attempted to explain why there still exists widespread resistance to the market order and why cultural evolution could not accomplish its task of selecting out rules that are not appropriate for emergence and maintenance of free market order.

To these questions Hayek offered rather *ad hoc* answers (for more see 'accounting for 'failure of evolution' below).

Hayekian cultural evolution represents successive replacement of instincts, or genetically inherited, innate (inborn) rules by learnt rules and traditions via imitation. In his last work Hayek was more explicit, and termed the first kind of rules as "rules of

²⁷⁴ In Hayek's view socialists and reactionaries are thus united: "The real leaders among the reactionary social philosophers are of course all the socialists. Indeed the whole of socialism is a result of that revival of primordial instincts, though most of its theorists are too sophisticated to deceive themselves that in the great society those old instincts could be satisfied by re-instating the rules of conduct that governed primitive man. So these recidivists join the opposite wing and endeavor to construe new morals serving the instinctive yearnings" (Hayek 1979, LLL 3, p. 169).

solidarity and altruism” (Hayek 1988, FC, p. 13) and called the second kind of rules “rules of the extended order” (Hayek 1988, FC, p. 13).

This means that there is no place for ‘solidarity’ or ‘altruism’ in the Great Society for, according to Hayek (1976, LLL 2, p. 110), the Great Society is merely “means-connected”²⁷⁵ whereas the tribal (face-to-face) society is “ends-connected”. Thus

“A Great Society has nothing to do with, and is in fact irreconcilable with ‘solidarity’ in the true sense of unitedness in the pursuit of known common goals. If we all occasionally feel that it is a good thing to have a common purpose with our fellows, and enjoy a sense of elevation when we can act as members of a group aiming at common ends, this is *an instinct which we have inherited from tribal society ...*” (ibid, p. 111; italics added).²⁷⁶

And socialism is “simply a re-assertion of that tribal ethics whose gradual weakening had made an approach to the Great Society possible” (ibid, pp. 133-4). This critique of social justice as atavism led Hayek (ibid, pp. 143-4; italics added) to say:

“much that will be truly social in the small end-connected group because it is conducive to the coherence of the working order of that society, will be *anti-social from the point of view of the Great Society*. The demand for ‘social justice’ is indeed an expression of revolt of the tribal spirit against the abstract requirements of the coherence of the Great Society with no such visible common purpose.”²⁷⁷

On the one hand, in the manner of rational reconstruction Hayek attempted to explain why solidarity, altruism and moral obligations to other unknown individuals are not appropriate in the Great Society.²⁷⁸ There must be a “reduction of the range of duties we owe to all others” or “attenuation of the obligation towards fellow members of

²⁷⁵ Cf. Hayek (1976, LLL 2, p. 110): “[In the Great Society] the chief common purpose of all its members is the purely instrumental one of securing the formation of an abstract order which has no specific purposes but will enhance for all the prospects of achieving their respective purposes.”

²⁷⁶ For the same reason there is no place for love in the Great Society for Hayek (1976, LLL 2, p. 150): “Love is a sentiment which only the concrete evokes, and the Great Society has become possible through the individual’s efforts being guided not by the aim of helping particular other persons, but the confinement of the pursuit of their purposes by abstract rules.”

²⁷⁷ Hayek (1976, LLL 2, pp. 144-5; italics added) argued further that “it did become part of the *ethos of the Open Society* that it was better to invest one’s fortune in instruments making it possible to produce more at smaller costs than to distribute it among the poor, or to cater for the needs of thousands of unknown people rather than to provide for the needs of a few known neighbors.”

²⁷⁸ Cf. Hayek (1976, LLL 2, p. 91; italics added): “It admittedly means that we make our *rational insight* dominate over our inherited instincts.”

the same small group,”²⁷⁹ if the same rules and morals are to be applied to the members equally in an extended order as Hayek (1976, LLL 2, p. 89 and p. 90; italics added) argued²⁸⁰:

“A system of rules intended for an Open Society and, at least in principle, meant to be applicable to all others, *must* have a somewhat smaller content than one to be applied in a small group.”

“Indeed the transition from the small group to the Great or Open Society – and the treatment of every other person as a human being rather than as either a known friend or an enemy – *requires* a reduction of the range of duties we owe to all others.”

On the other hand, Hayek invoked again evolutionary arguments to criticize social justice when he argued that

“Such demands for justice are simply inappropriate to a naturalistic evolutionary process – inappropriate not just to what has happened in the past, but to what is going on at present. For of course this evolutionary process is still at work. Civilization is not only a product of evolution – it is a process; by establishing a framework of general rules and individual freedom it allow itself to continue to evolve. This evolution cannot be guided by and often will not produce what men demand. Men may find some previously unfulfilled wishes satisfied, but only at the price of disappointing many others. Though by moral conduct an individual may increase his opportunities, the resulting evolution will not gratify all his moral desires. *Evolution cannot be just*. Indeed, to insist that all future change be just would be to demand that evolution come to a halt.” (Hayek 1988, FC, p. 74; italics in the original).

Accounting for ‘failure’ of evolution

Hayek’s dilemma stems from the difficulty of counting on his theory of evolution for the emergence and development of market order on the one hand and of explaining why the current state deviates from his ideal of Great Society and free market order.

²⁷⁹ Hayek (1976, LLL 2, p. 90 and p. 91); see also Hayek (ibid, pp. 144-6).

²⁸⁰ Hayek (1976, LLL 2, p. 88) termed this as the “spatial range of social justice”, which is strongly reminiscent of the term “social distance” that Viner used in interpreting Adam Smith’s sympathy or sentiments in the context of *The Wealth of Nations*. See Viner (1972, p. 80). Hayek’s view of social justice in this regard is remarkably similar to Coase’s reading of Adam Smith: “The market is not simply an ingenious mechanism, fueled by self-interest, for securing the co-operation of individuals in the production of goods and services. In most circumstances it is the only way in which this could be done. ... The great advantage of the market is that it is able to use the strength of self-interest to offset the weakness and partiality of benevolence, so that those who are *unknown, unattractive, or unimportant*, will have their wants served” (Coase 1976, p. 544; italics added).

As a liberal critic of socialism, welfare state, and of contemporary democracy Hayek needed to explain why liberal economy and society came to degenerate, which he saw to a large extent realized in the 19th century mostly in parts of Europe, and the revival of which he set himself his lifelong task.²⁸¹ As he opted for evolutionary arguments as a non-rationalistic basis of his ‘economics and philosophy of liberty’, he needed to deliver explanations of the ideal of liberalism and of liberal economy and society in that context. That is, since his evolutionism primarily explains the social or cultural evolution toward the Great Society²⁸², he had to explain the reasons of there being ups and downs of liberalism and liberal society and of their still existing ideas and attempts of individuals and groups that resist the ‘smooth’ and ‘proper’ working of evolutionary process, from which they would only benefit in the end, if they just let the evolution take their course.²⁸³

This tricky problem is also interrelated with a shortcoming of immanent criticism. It cannot deal with the development which is ‘wide of the mark’.²⁸⁴

At various places in his work Hayek offered some explanations which can be seen as his accounts of ‘failure’ of evolution or of why the evolution has not fulfilled its task

²⁸¹ Hayek lamented in the introduction of *Constitution of Liberty*: “It has been a long time since that ideal of freedom which inspired modern Western civilization and whose partial realization made possible the achievements of that civilization[0] was effectively restated. In fact, for almost a century the basic principles on which this civilization was built have been falling into increasing disregard and oblivion. Men have sought for alternative social orders more often than they have tried to improve their understanding or use of the underlying principles of our civilization. It is only since we were confronted with an altogether different system that we have discovered that we have lost any clear conception of our aims and possess no firm principles which we can hold up against the dogmatic theory of our antagonists” (Hayek 1960, CL, pp. 1-2). And he stated further: “Though it was from an original concern with problems of economic policy that I started, I have been slowly led to the ambitious and perhaps presumptuous task of approaching them through *a comprehensive restatement of the basic principles of a philosophy of freedom*” (ibid, p. 3; emphasis added).

²⁸² Forsyth (1988, p. 245; emphasis in the original) points to the ambiguity in Hayek’s usage of the ‘Great Society’ in this regard: “The status of the Great Society ... is profoundly ambiguous. At times Hayek simply takes it to be the dominant reality of our time into which all individuals and human organizations are integrated. More frequently, however, he argues that the Great Society *ought to be* the dominant reality of our time, providing the yardstick by which all individual and organizational activities are to be tested.”

²⁸³ Somewhat boldly remarked: As Hayek detected the deviation of the actual state of affairs from the course of evolution envisioned by his theory, we can only infer that *either* his theory *or* the real process of evolution must be wrong. As Hayek seemed to suggest that the latter is the case, his view is not a far cry from ‘equilibrium thinking’.

²⁸⁴ Cf. Kukathas (1989, p. 105): “The theory of spontaneous order seems to cut both ways: it tells against the wisdom of planning for ‘social justice’; but denies the possibility of reform once the damage has been done.”

to a fuller extent. A central logic of his explanation of ‘ups and downs’ or of ‘deviation’ is revealed in Hayek’s statement that:

“We live at present under the governance of two different and irreconcilable conceptions of what is right: and after a period of ascendancy of conceptions which has made the vision of an Open Society possible, we are relapsing rapidly into the conceptions of the tribal society from which we had been slowly emerging. ... Socialism is simply a re-assertion of that tribal ethics whose gradual weakening had made an approach to the Great Society possible. The submergence of classical liberalism under the inseparable forces of socialism and nationalism is the consequence of a revival of those tribal sentiments²⁸⁵” (Hayek 1976, LLL 2, pp. 133-4).

In Hayekian evolutionary context recurrence or revival of rules, morals or sentiments which are not appropriate for the Great Society must serve as a *exogenous* factor for disturbing the Great Society and preventing its full realization in the process due to evolution. That is, it must be explained why the task of evolution, that of selecting rules and institutions appropriate for extended order, is not yet accomplished fully.

One plausible explanation is that the history of civilization of human beings is not long enough; the evolution is an ongoing process; it would take more time till the evolution takes its full effect:

“The moral sentiments which made the Open Society possibly grew up in the towns, the commercial and trading centers, while the feelings of the large numbers were still governed by the parochial sentiments and the xenophobic and fighting attitudes governing the tribal group. The rise of the Great Society is far too recent an event to have given man time to shed the results of a development of hundreds of thousands of years, and not to regard as artificial and inhuman those abstract rules of conduct which often conflict with the deeply ingrained instincts to let himself be guided in action by perceived needs” (Hayek, LLL 2, pp. 145-6).

Thus, in Hayek’s expression, “we are not yet mature enough” (Hayek 1973, LLL 1, p. 33), as he argued that:

²⁸⁵ Hayek (1976, LLL 2, p. 147) also referred to ‘fragility of liberty’ in this context: “This conflict between what men still feel to be natural emotions and the discipline of rules required for the preservation of the Open Society is indeed one of the chief causes of what has been called the ‘fragility of liberty’.”

“The revolt of the abstractness of the rules we are required to obey in the Great Society, and the predilection for the concrete which we feel to be human, are ... merely a sign that intellectually and morally we have not yet fully matured to the needs of the impersonal comprehensive order of mankind²⁸⁶” (Hayek 1976, LLL 2, p. 149).

This is also related to Hayek’s critique of social justice as atavism, which I showed above.

Secondly, this recurrence is closely related to “a strong revival of organizational thinking and a decline in the understanding of the operation of the market order”:

“An ever growing proportion of the members of society work as members of large organizations and find their horizon of comprehension limited to what is required by the internal structure of such organizations. While the peasant and the independent craftsman, the merchant and the journeyman, were familiar with the market and, even if they did not understand its operation, had come to accept its dictates as the natural course of things, the growth of big enterprise and of the great administrative bureaucracies has brought it about that an ever increasing part of the people spend their whole working life as members of large organizations, and are led to think wholly in terms of the requirements of the organizational form of life. ...

Most people are no longer aware of the extent to which the more comprehensive order of society on which depends the very success of the organizations within it is due to ordering forces of an altogether different kind²⁸⁷” (Hayek 1976, LLL 2, p. 134 and 135).

Hayek had no objections to big businesses or monopolies as such if they result from superior efficiency, and unless they are ‘entrenched’ monopolies due to the government conferring exclusive rights or privileges. If their growth inevitably leads to increase in the ‘relative share’ of organizations in an overall spontaneous order, the tendency to the increase in the organizational thinking might be seen as an inherent one (or *endogenous* factor) of disturbing or detaining the ‘right’ course of evolution. At this juncture Hayek became once again a conventional Enlightenment thinker turning away from relying on ‘naturalistic’ evolutionary selection process and emphasized the role and even task or duty of the political philosopher, which is to de-

²⁸⁶ Hayek (1976, LLL 2, p. 149) spoke of “the savage in us” in this regard.

²⁸⁷ See also Hayek (1976, LLL 2, p. 146; emphasis added): “At a time when the great majority are employed in organizations and have little opportunity to learn *the morals of the market*, their intuitive craving for a *more humane and personal morals corresponding to their inherited instincts* is quite likely to destroy the Open Society.”

liver ideas that guide the majority into right insights into the working of the comprehensive spontaneous order of society and its evolution:

“Our views both about what the consequences of our actions will be and about what we ought to aim at are mainly precepts that we have acquired as part of the inheritance of our society. These political and moral views, no less than our scientific beliefs, come to us from those who professionally handle abstract ideas. It is from them that both the ordinary man and the political leader obtain the fundamental conceptions that constitute the framework of their thought and guide them in their action.” (Hayek 1960, CL, p. 112).²⁸⁸

Thirdly, it is government interference, another *exogenous* factor, which accounts for the deviation of actual state from ideal course of evolution (cf. Hayek 1988, p. 20, pp. 43-5; Denis 2002).

Whether exogenous or endogenous factors cause the ‘recurrence’ or the ‘deviation’, the main underlying reason is that individuals or groups are not fully aware of the ‘system viability’. However, Hayek’s attempts were to construct a theory where individuals’ interactions, obeying the rules conferred on them by evolution, lead to a beneficial result without their caring about the ‘system viability’.

As Hayek argued that

“To submit comprehendingly to those rules which have made the approach to the Open Society possible ... and not to blame some imagined personal agent for any misfortune that we encounter, evidently requires a *degree of insight into the working of a spontaneous order which few persons have yet attained*” (Hayek 1976, LLL 2, p. 149; italics added);

Hayek could never really be optimistic of the course of evolution until more and more people than ‘the few’ come to acquire a high degree of insight into his theory of spontaneous order and cultural evolution.

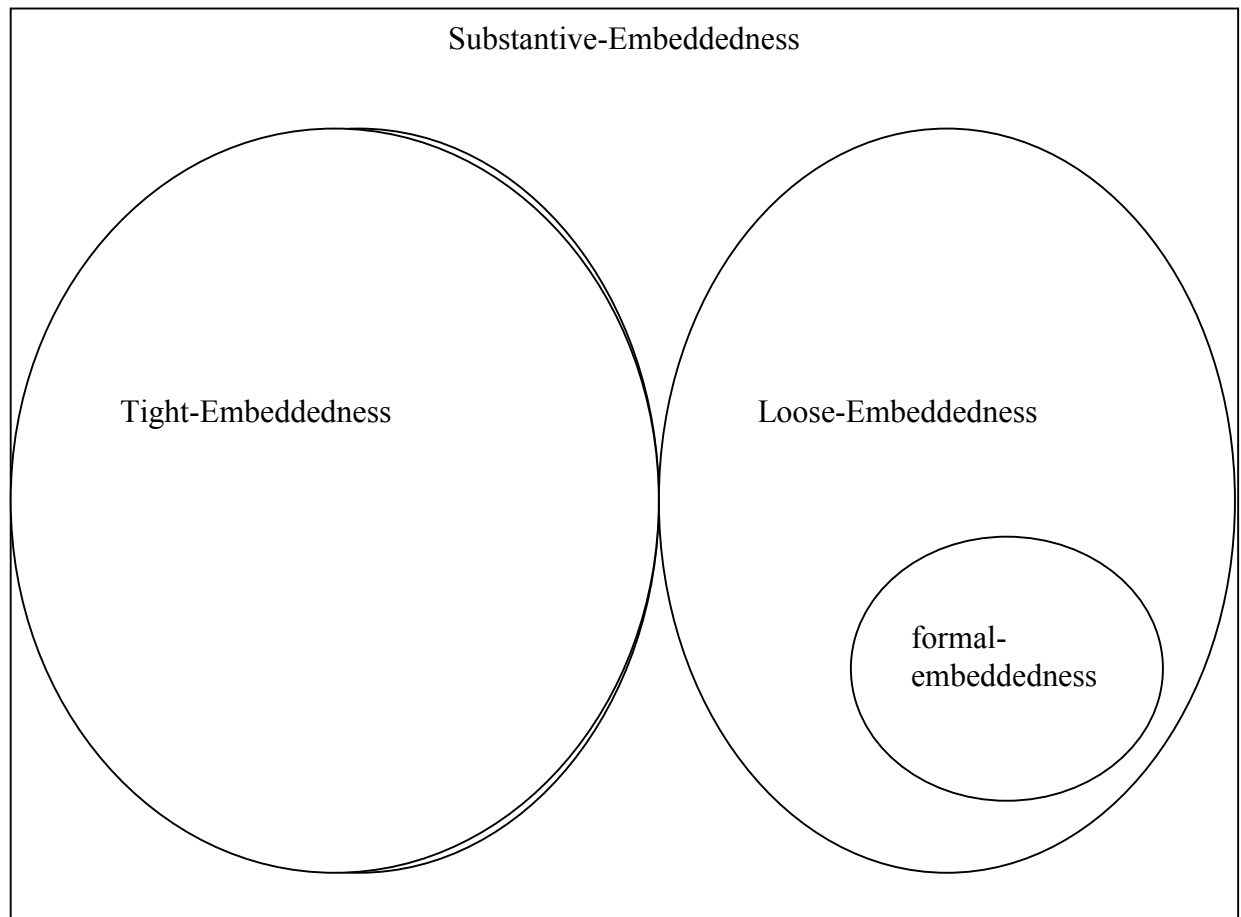
²⁸⁸ Hayek (1960, CL, p. 115) argued further: “It is by insisting on considerations which the majority do not wish to take into account, by holding up principles which they regard as inconvenient and irksome, that he [the political philosopher] has to prove his worth.”

7. Conclusion

What Hayek tries to establish with his twin ideas of spontaneous order and cultural evolution is (1) how, in contrast to neoclassical approach, an ideal working of market economy can be conceived in spite of introducing social and institutional contexts and (2) how it can be ensured that only those institutions could be provided that underpin the ideal market economy. In the first step, Hayek demonstrates that ideal working of market economy and its merits cannot be appositely grasped by neoclassical economics (knowledge problem and knowledge argument). In the second step, the ideal working of a market economy is best associated with individual liberty, of his definition, by introducing institutional dimensions (institutional argument). In the last step, nonetheless, institutional factors must be secured which do not modify (for him illegitimately interfere with and ultimately undermine) the ideal working of market economy in his perspective (evolutionary argument). This last step also serves to establish the universal validity of his ideal market economy beyond different social and institutional contexts (see below).

Embeddedness:

(non-embeddedness → formal embeddedness → loose embeddedness → substantive embeddedness)



My Polanyian critique is that Hayekian theory of Free Market Economy, which is part of his 'economics and philosophy of liberty', cannot claim universal validity. Free Market Economy can be based on either formal embeddedness or loose embeddedness as a specific case of substantive embeddedness. Hayek chose the first option as it best firmly 'embeds' his economics in his liberalism. There also exist arguments in his theory which could indicate FME as loose-embeddedness. There is, indeed, apparent similarity between FME as formal-embeddedness and FME as loose-embeddedness.

However, basing FME on loose-embeddedness implies endorsing tight-embeddedness as a case of substantive embeddedness, which Hayek could not accept. For to do so means accepting wider range of state activities in terms of economic and, above all, social policy. Tensions and even contradictions in his theory of FME result from difficulty of refuting substantive embeddedness once one accepts formal embeddedness.

By pointing to and criticizing neoclassical notion of equilibrium and of perfect competition and perfect knowledge Hayek moved equilibrium economics from non-embeddedness to formal embeddedness. By introducing institutional dimensions and reinforcing them with evolutionary arguments, Hayek tried to avoid ‘falling into’ FME as loose-embeddedness, for, FME as loose-embeddedness can neither theoretically exclude possibility of SME as tight-embeddedness nor empirically make a substantial critique on the real operation of SME. He failed, however, in his attempt theoretically to establish FME as formal embeddedness as the only possible (or, at least, superior) way of ‘organizing’ a market economy. He failed to deliver the substantial arguments needed to defend his theory of FME as formal embeddedness from a theory of FME as loose-embeddedness.

In this sense, I argue that a theory of SME can explain FME but not the other way round. Further, a theory of SME, which follows from the insights of Polanyian embeddedness, is a more general theory of market economy,.

In this context, ‘social justice’ may be a ‘category mistake’ from the perspective of Hayek’s theory of FME as formal embeddedness. However, from the perspective of substantive embeddedness it is his *critique* of social justice that represents a ‘category mistake’.

With his ‘first’ transformation Hayek constitutes his theory of FME as formal embeddedness in a wider context of his ‘economics and philosophy’ of liberty. I argue that in case of Hayek’s ‘second transformation’, which can be the only way of resolving tensions and contradictions in his theory of order and evolution, Hayek might have come to embrace Polanyian concept of substantive embeddedness via theory of

FME as loose-embeddedness, and not as a formal-embeddedness. However, he failed to do so.

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