

# Knowledge, Economics, and Coordination: Understanding Hayek's Legal Theory

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## Abstract

Legal scholars and economists alike have heavily criticized F.A. Hayek's legal theory. According to Richard Posner (2003), Hayek's legal theory is "formalist" and serves as a useless guide for legal scholars and judges. Ebenstein (2001, 2003) argues that Hayek's arguments in technical economics fail and therefore his research program in economic science should be abandoned, but that his broader social philosophy and theory are worthy of attention by serious scholars. Here we argue that these criticisms are misplaced. We contend that Hayek's legal theory cannot be separated from his economic theory. To establish this point, we trace the evolution of Hayek's thought from his earlier writings in technical economics to his later writings on legal theory. Both Posner and Ebenstein fail to appreciate the subtlety of Hayek's legal theory because they understand Hayek's work in law in isolation from his work in economics.

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## 1. Introduction

Friedrich A. von Hayek was arguably the most important classical liberal political economist of the twentieth century. Over the course of his career, Hayek's research extended well beyond the discipline of economics. With Mises, Hayek was responsible for arguing that rational central planning of an economy was impossible. His technical writings in economics offered a systematic critique of Keynesian macroeconomics and defended decentralized markets. His *The Road to Serfdom* remains a classic among classical liberals, and it has consistently been ranked among the 100 most important books of the 20<sup>th</sup> century. His later writings on political theory, legal theory, and cognitive psychology addressed many important issues in classical liberalism and political economy, and his research program as a whole has inspired hundreds of papers and several biographies.

At first glance, Hayek's research program appears to be the story of a dilettantish puzzler who was constantly jumping into new disciplines. Yet, when one looks closely at Hayek's work, there are at least three clear themes that are emphasized throughout:

- (1) The role of subjective knowledge in individual decision-making.
- (2) The "compositive method" in which institutions must be explained as the result of "bottom up," individual action.
- (3) A clear recognition that economic phenomena do not exist independent of certain institutional, cultural, and legal structures.

This final point is arguably the most important point in Hayek's work, and the most relevant one for our discussion. As Peter Boettke (1999) argues, Hayek's entire research

program can be understood as a program that recognizes and appreciates the overlap between economics, politics and law.

Since Hayek's body of work covered several disciplines, one may be tempted to look at his research as a series of unconnected events. We contend that a more fruitful and more accurate interpretation of Hayek is to read his work *as if* it is a coherent research program driven by a few fundamental questions. While other scholars have discussed the connections between Hayek's economic theory and his work in cognitive psychology and politics,<sup>1</sup> this paper will illustrate the links between Hayek's economic theory and his legal theory.

As we will make clear in this paper, Hayek's legal theory cannot be correctly understood in the absence of his economic theory. In the next section, we trace the evolution of Hayek's thought from his earlier writings on technical economics to his later writings on legal theory. In so doing, we seek to highlight the critical overlaps and influences between Hayek's works in each discipline. We then turn to recent criticisms of Hayek's legal theory. According to our argument and our interpretation of these criticisms, the critics have failed to fully understand and appreciate Hayek's legal theory. Those who fail to appreciate the connections between Hayek's economic theory and his legal theory do so at their own peril. As this paper suggests, two important critics of Hayek, Richard Posner (2003) and Alan Ebenstein (1999) completely miss the point by separating Hayek's legal theory from his economic theory.

## **2. Hayek's Economics & Legal Theory**

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<sup>1</sup> For a discussion of the connections between Hayek's political theory and his work in economics, see Boettke (1999). Caldwell (2000) and Horwitz (2000) discuss the connections between Hayek's economic theory and his work in cognitive psychology.

## 2.1 Hayek's Economics

Beginning with his 1928 essay, Hayek established the central problem of economics as one of *coordination*. Hayek was preoccupied with the same question that puzzled Adam Smith some 150 years earlier: how does order emerge from the unintended actions of millions of economic actors? His earliest writings in economics were focused on tracing out the implications of the coordination economic activities through time. As his work matured, Hayek started to emphasize the institutions necessary for this dovetailing of plans among different individuals. His work on imputation, capital and interest theory, trade cycle theory, and monetary theory all had a “coordinationist” theme.

In an economy characterized by complex capitalist production, the signals produced by market institutions guide the process of coordination. Individuals allocate resources, including their own time, in a manner that satisfies the demands of others. Their decisions over how to allocate their time, labor, and capital are based on the local knowledge available to them. If the signals they are receiving at the local level are either absent or distorted, production plans and consumption decisions will be misdirected. Due to the false signals being sent, some business decisions will end up failing; other business decisions will never be pursued. In a world of uncertainty, market institutions help guide business decisions. When these institutions are not allowed to function properly, error and inefficiency can result.

The most important market institution in guiding individual decisions is the price system. In the 1930s and 1940s, Hayek became preoccupied with the role the price system played in the dissemination of knowledge. During this time, Hayek also focused on how the market order would tend toward realizing the benefits from exchange and how interventions affected the market order. According to Hayek, and Austrian

economists in general, market prices are the outcome of a purposeful chain of events initiated by individuals to better their position (see Cowan and Rizzo 1996).

In the 1930s and 1940s, neoclassical economists were also interested in how markets achieve efficient outcomes. According to standard neoclassical theory, if we make a few assumptions about how markets work (e.g., individuals have perfect information, there is free entry and exit from a market, etc.), an efficient allocation of resources can be reached. The focus of the neoclassical theory was on end-states, and most of their work either minimized or completely ignored the role of entrepreneurship in the market process.

In his rendering of the market order, Hayek focused less on equilibrium assumptions and more on the division of knowledge within society. The central issue for Hayek was the limits of man's knowledge. A modern economy with an advanced division of labor requires the cooperation of millions of individual actors. Given that each individual actor can only know the particulars of a small part of the economy, the coordination of economic activities is a critical issue.

Hayek's interest in the division of knowledge was best articulated in his 1937 paper, "Economics and Knowledge" and his 1945 paper, "The Use of Knowledge in Society." According to Hayek (1937: 50-51), the central question of all social science 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.

"Economics and Knowledge" was Hayek's first attempt to articulate what was wrong with the trend in policy proclamations based on the neoclassical model of the economic

system.<sup>2</sup> Hayek pointed out that neoclassical models incorrectly assumed that the process of coordination had been completed. The initial assumptions of perfect information, homogeneous goods, zero transaction costs, and free entry/exit that allowed for efficient outcomes in the neoclassical model completely overlooked the process of market adjustment.

As Hayek correctly pointed out in his 1937 article, the neoclassical model explained equilibrium by assuming an equilibrium starting point.<sup>3</sup> The profit and loss signals sent to participants in the market process lead to learning and the spread of information. The learning and information produced in the market process is already assumed away in the perfect competition model of neoclassical economists. Hayek's 1937 article recognized this contradiction, and he went on to argue that "if we want to make the assertion that, under certain conditions, people will approach the state, we must explain by what process they will acquire the necessary knowledge" (1937: 46). In other words, in order to say anything meaningful, economic theory must have some notion of how agents learn under alternative institutional environments.

Hayek's understanding of the market process caused him to shift from a behavioral understanding of the market order to a focus on institutional explanations. According to Hayek, the logic of choice is universal. In all cases – no matter time, nor place – individuals arrange the means at their disposal to best obtain the ends they desire.

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<sup>2</sup> Earlier Hayek had placed the blame for the interventionist bias in public policy on the popularity of the ideas of historicism and institutionalism, but by the mid-1930s he came to understand that developments in neoclassical economics also reinforced the bias. See Hayek's essay "The Trend of Economic Thinking" which was originally published in 1933. After Lange's criticisms of the Mises and Hayek position on socialist planning, Hayek could no longer maintain his position that only the anti-theoretical economics of the historicists and institutionalists could generate an argument for interventionism. In the hands of Lange, it was evident that neoclassical economics could be marshaled in favor of socialism. This is what led Hayek to rethink the foundations of economic inquiry.

<sup>3</sup> In the contemporary Austrian literature, Garrison (1982) has pointed out the "equilibrium always" position of neoclassical economics where individuals and markets are always in equilibrium. Garrison goes on to argue that Austrian economists offer a more reasonable position of individual equilibrium coupled with overall market disequilibrium.

Since individuals act in a means/ends framework, it is not human behavior that explains different outcomes, but, rather the institutional environment in which they are operating.

The institutional environment directs activities, and it either facilitates coordination or distorts that process. Some institutional environments allow individuals to learn and act upon the information that is dispersed throughout the economy; other institutional environments, such as price controls, prevent information about scarcity from spreading through the economic system. According to Hayek, then, the concern for economists must be in determining which institutional settings best allow individuals to learn and act on dispersed information. It is only through widespread coordination that the full gains of an advanced exchange economy can be achieved.

Having provided an overview of the underlying concepts of Hayek's economics – coordination, the dispersed nature of knowledge, and the role of the institutional environment on individual behavior – we now turn to his political and legal theory. Hayek's political and legal theory stem directly from the realization that the institutional setting affects individual behavior and the amount of learning that occurs in an economic system. As such, it is not possible to understand his work in law and politics without keeping in mind these fundamental concepts.

## **2.2 Hayek's Political and Legal Theory**

Hayek's broader interest in political and legal theory makes sense when we recognize that coordination was the central concern of his research program. Since the coordination of economic activity does not occur in a vacuum, it is crucial to explore how other important institutions—particularly, political and legal institutions—affect the coordination of plans. Since Hayek's political and legal writings are intricately

connected to his work in economics, “We are confronted with the dual tasks of reading his mature writings in political economy and social philosophy back on his technical economics, and his technical economics into his writings in political economy and social philosophy...” (Boettke 1999: xxv). Reading Hayek’s political and legal theory in the absence of an understanding of his economic work means that the reader is unable to fully grasp what Hayek is trying to accomplish.

For example, Hayek’s critique of socialism can best be understood as a critique of how certain political and legal institutions affect economic activity. Building on the work of Ludwig von Mises, Hayek argues that rational central planning of an economy is impossible because information is dispersed among millions of agents in an economy. Moreover, the nature of this information is not objective, but, rather, subjective and extremely contextual. Even though individuals living under socialism will still engage in the pure logic of choice, they will be unable to learn how to coordinate their activities with others and they will lack the incentive to do so on a widespread basis. At the most general level of analysis, Hayek’s critique of socialism predates New Institutional Economics by arguing that political institutions will either assist in facilitating or distorting the coordination of plans.

Hayek’s work in political economy has proven to be extremely prescient and relevant for current debates in growth theory.<sup>4</sup> For Hayek, a respect for private property, a well-functioning rule of law, and a stable monetary order were crucial for individual experimentation, learning, and widespread coordination. In the *Constitution of Liberty* (1960), he argues that these aforementioned institutions provide a predictable environment within which people can orient their behavior (1960: 148-161).

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<sup>4</sup> See, for example, Glaeser and Shleifer (2002) and Mahoney (2001).

Hayek's political economy can be read as a "robust" political economy. He realized that each individual is imperfect and as such we must develop the rules of the game so that the best of all possible worlds will not be the enemy of the "good" society. Hayek summed this up, as well as the connection of his research program with that of the Scottish Enlightenment program, when he wrote:

[T]he main point about which there can be little doubt is that [Adam] Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that it is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid (1948: 11-12).

Hayek continued the development of this political economy project in his three-volume *Law, Legislation and Liberty* (1973, 1976, 1979). The main theme of this trilogy is that rules must be general, non-arbitrary, and equally applied to all individuals. This pure "Rule of Law," as Hayek calls it, must serve as the backdrop for imperfect agents. Given a predictable legal code, individuals can learn and adapt their behavior in order to coordinate their activities with those of others.<sup>5</sup>

Consistent with the generality principle mentioned above, Hayek claims that in a free society only the general welfare can be pursued and not the particular aims of any individual within society. According to Hayek, many contemporary notions of social justice are focused on the particular case of individuals within the general order. But, in Hayek's system, justice can only be maintained at the level of the general legal framework and rules of the game. Specific actions designed to remedy certain instances

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<sup>5</sup> Mario Rizzo (1980) stressed the need for clear and predictable law to serve as a guide post for economic actors caught up in the ceaseless flux of economic activity. Richard Epstein (1995) has developed this Hayekian point about simple rules for a complex world into a coherent legal theory.

of “injustice” will fail to effectively remedy the situation and will undermine the general system.

To understand Hayek’s argument, we must first acknowledge that political decisions are never about particular distributions of resources. Instead, political decisions are decisions that affect the rules of the economic game. These rules create a set of expectations and a resulting pattern of exchange, production and distribution. The “mirage of social justice,” is the belief that specific distributional outcomes can be picked independent of the very process through which exchange and production takes place. The rules of just conduct serve to govern the means by which various purposes and plans are pursued. As such, these rules serve to reconcile the actions pursued by disparate individuals within the general order governed by these rules. In contrast, a command serves a particular purpose and as such is in direct conflict with rules of just conduct. Put simply, discriminatory laws undermine the rules of just conduct and the framework of a just society.

After describing and defending the “rule of law” in Volumes 1 and 2 of *Law, Legislation and Liberty*, Hayek makes the case for political constraints in the third and final volume (1979). Recognizing the role interest groups play in democratic political systems, Hayek argued that the problem with limited democracy is that it becomes “the playball of all separate interests it has to satisfy to secure majority support” (1979: 99). In doing so, the government becomes unable to accomplish the tasks required for good governance. Thus, constraints are necessary to avoid the devolution into arbitrary, unconstrained, interest group government.

Public choice theory brings to our attention the inherent tensions within democratic politics. Specifically, there is the tendency for those in political positions to

utilize their power to serve particular ends. Hayek understood this tension, and he further argued, in the epilogue of *Law, Legislation and Liberty*, that our own evolutionary heritage reinforces the pressure to move from abstract rules to particular rules. This is due to the fact that our innate notions of social justice derive from a small group of norms of tribal society. As such, they are not the requirements for an economy characterized by advanced specialization and exchange. Public opinion and the logic of democratic decision-making are at odds with the institutional restrictions required for a social order in which public opinion can be expressed freely and the selection of those in political positions is subject to democratic vote.

At this point, one can hopefully see the connection between Hayek's various strands of work. A narrow reading of Hayek's later work on political and legal theory may seem far removed from his early work on technical economics. This overlooks the underlying inquiry that drove all of Hayek's research, which basically asked how individuals learn to coordinate their economic activities with those of others under varying institutional arrangements. The economic way of thinking in Hayek's rendering lead us to focus not a set of behavioral postulates, but instead leads us to focus on how alternative institutional environments impact on individual and group behavior.<sup>6</sup> In his early work he focused on coordination aspects of the capital structure, interest rates and monetary theory; the in the middle of his career, he emphasized the signals provided by the price system as the source of complex coordination among diverse (and often apparently divergent) individuals; in his later work, his concern with coordination became more focused on how varying political and legal environments facilitated or distorted coordination. The key point is that the fundamental question in each case is the

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<sup>6</sup> Following the standard nomenclature in New Institutional economics we define institutions here at the *de facto* (informal) and *de jure* (formal) rules of the game for social intercourse and their enforcement.

same. Thus, Hayek's later research is a direct product of his early writings, and his move towards political and legal theory was the next logical step in his research program.

## 3. Recent Treatments of Hayek's Legal Theory

### 3.1. Richard Posner

As we have argued throughout this paper, F.A. Hayek's writings in political and legal theory should not be separated from his writings in economic theory. Despite the dangers and carelessness involved in criticizing a scholar without appreciating the full scope of their research program, many have been quick to criticize Hayek for alleged inconsistencies in his writings. Among Hayek's critics in the field of legal theory, there is nobody more prominent in stature and harsh in his criticism than Richard Posner.

Posner's central criticism of Hayek can be found in his chapter, "Kelsen versus Hayek: Pragmatism, Economics, and Democracy" in *Law, Pragmatism, and Democracy* (2003). Posner, whose understanding of Hayek's legal theory is based on Hayek's *Law, Legislation, and Liberty*, is deeply troubled by Hayek's legal theory. According to Hayek, judges should not be creating law anew. Instead, they should serve as professionals who decide "whether conduct under dispute conformed to recognized rules" (Hayek 1973: 87). According to Hayek's legal theory, judicial decisions should be based on precedent. Judges should not depart from precedent even if public opinion goes against their decision, or even if the expected costs of the decision exceed the benefits.

As Posner correctly points out (Posner 2003: 80), Hayek's legal theory does not allow for any kind of judicial discretion. It would reduce judges to interpreters of the law rather than creators. His rejection of judicial discretion prevents judges from pursuing

their own interests—whether they be liberal, conservative, environmental, or enlightened interests—while serving on the bench.

In rejecting judicial discretion, Hayek is also rejecting the economic analysis of law that Posner is arguing for. For Hayek, whenever judges depart from a precedent-based approach to lawmaking, his ideal rule of law is being violated. Hayek's legal theory makes no distinction between different types of departures—whether they be departures that are well-informed by economic theory (a la Posner) or departures for the sake of social justice.<sup>7</sup> Hayek disapproves of all forms of judicial activism equally.

In contrasting Kelsen's *Pure Theory of Law* with Hayek's *Law, Legislation, and Liberty*, Posner reaches the “surprising” conclusion that:

Kelsen's philosophy of law opens a space for economic analysis, and in particular for the use of economics by judges in a wide range of cases that come before them...Hayek's philosophy of law closes that space, forbids judges to have anything to do with economics (2003: 51).

Posner is “surprised” because he expected Hayek's legal theory to leave room for the kind of cost-benefit judicial decision-making that he (Posner) has defended. At the same time, Posner expected Kelsen's “pure” theory to be formalistic and inflexible to cost-benefit decision-making. What he finds instead is that Hayek is a formalist who leaves no room for an economic approach to law, while Kelsen's system is open to an economic approach.

Posner thinks that Hayek's argument for constraining judges is flawed. Posner, who clearly understands the dangers involved in judicial activism, rejects Hayek's argument because he does not want his (Posner's) economic approach to law taken off

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<sup>7</sup> Hayek's argument against the activist law and economic program of Posner follows directly from his critique of market socialism. In essence, what Posner suggests the Judge can accomplish is analogous to what Lange thought the economists working at the Central Planning Board could accomplish. Several writers following up on Hayek's ideas have made this critique of Posnerian law and economics starting with Rizzo. A representative contribution to this line of argument can be found in Stringham (2001).

the table. While Hayek's argument for judicial constraint might be a noble and inspiring project in that it rejects all forms of judicial activism, Posner cannot swallow Hayek's argument because he is certain that his form of judicial activism is the one true and permissible form of judicial activism. Posner concludes that Hayek's legal theory rejects economic analysis, and in so doing Hayek leaves judges with nothing to guide their decision-making (282).

Clearly, Posner and Hayek have different notions of the economic analysis of law in mind when positing their legal theories. Posner's economic approach is a broadly empirical one that is grounded in the perfectly competitive framework. Posner wants judges to base their decisions strictly on a cost-benefit analysis, and he is confident that the common law is already tending towards efficiency. Hayek's approach, by contrast, is a process-oriented one that is more concerned with patterns of behavior rather than precise results. Hayek is skeptical of cost-benefit analyses and other aggregate measures available to policymakers, and he would undoubtedly reject Posner's piecemeal approach to the law. Since it is impossible to know all of the unintended consequences of any particular policy and all of the subjective costs involved in different policies, Hayek would argue that Posner's approach places far too much faith in a judge's intellect.<sup>8</sup>

While Posner and Hayek disagree over the role of judges in the legal system, it does not necessarily follow that Hayek has "a different economic theory of law from that of people like [Posner]" (Posner 2003: 282). After all, Hayek and Posner undoubtedly share a great deal of common ground when presented with similar economic puzzles.

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<sup>8</sup> The criticisms that Posner recognizes would come at law and economics from a consistent reading of Hayek are, in fact, precisely those that have been made by two scholars who contributed so much to the development of the field of law and economics in the 1960s and 1970s--- Ronald Coase and James Buchanan. The simplest way to describe the difference is that Posner was interested in using the tools of economic reasoning to assess the efficiency of legal rules, whereas Coase was interested in exploring how alternative legal arrangements impacted on economic performance.

Both would oppose regulation and intervention into markets. Both recognize the superiority of markets over central planning. And, both understand the intricate relationship between institutions—both political and legal—and market outcomes. Moreover, both tend to reach free market conclusions and policy prescriptions when engaging in economic analysis. While Hayek is not interested in the positivist project being promoted by Posner, he is still in general agreement with Posner on the fundamental laws of economics.

The disagreement between Hayek and Posner is instead the result of two competing visions of the economist's role in the legal system specifically and the economic system more generally. Posner has a vision of judges as saviors. If judges could only become better informed about the laws of economics, legal decisions could become more efficient and less biased. According to Posner, it is not legal activism *per se* that is responsible for bad law, but, rather, the wrong kind of legal activism that has produced bad law.

Consistent with his earlier work, Hayek is skeptical of any kind of activism. For Hayek, policymakers attempting to fine-tune markets and the economy do more harm than policymakers who adhere to strict and general rules. The same goes for judges. Even activist judges, like Posner, who are well read in economics can do a great deal of harm by seeking to remedy all legal problems through the use of cost-benefit analysis. As Hayek makes clear, those who think that judges or intellectuals can fully comprehend all of the costs and consequences of their actions are guilty of the fatal conceit. The information needed to make well-informed judicial decisions (i.e., weighing the costs and benefits of different policies) is not readily available to judges. If this information could

be obtained, the problem of social planning—whether it be one of legal decision-making or rationally planning an entire economy—would be overcome.

Thus, Hayek's legal theory is a consistent application of his economic theory.<sup>9</sup> Since knowledge is dispersed throughout an economy, it is impossible for policymakers *and* judges to successfully steer an economy or a legal system in a direction that guarantees the maximization of social welfare. The best policymakers and judges can do is provide some general rules of the game within which players of the game can operate. Or, as Vernon Smith puts it in his recent Nobel address, "Rules emerge as a spontaneous order—they are found—not deliberately designed by one calculating mind" (2003: 500). Thus, the proper role for judges is to discover rules and watch the law grow rather than attempt to force the law to grow. Hayek's economics is no different from Posner's, but Hayek thinks economics teaches us humility; Posner thinks economics gives us the knowledge to undertake an activist role in planning certain aspects of the social order.

### 3.2 Alan Ebenstein

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<sup>9</sup> Perhaps the best way to illustrate this is to go back to a central issue in the debate with market socialism over the role the principles of marginalism. Various 19<sup>th</sup> century socialist had argued that once the transition to socialism had been made that the laws of economics would disappear. Scholars such as Barone, Pareto and Wieser demonstrated that this was mere intellectual silliness. All the marginal principles established was the conditions of optimality. If the socialist system was to achieve the rationalization of production that it promised, then it would have to meet the optimality conditions established by the marginalist analysis of neoclassical economics. Capitalism and Socialism, in other words, faced the same economic problem of allocating scarce resources among competing ends in the most effective way possible, they would just choose different methods of allocation --- one through the decentralized mechanism of the price system and the other through the conscious decisions of the central planning board. Translated into economic language to achieve efficiency meant that the "prices" for goods and services would need to be set equal to marginal costs, and that production would have to be at that level which minimized average costs to ensure that all least cost technologies were being employed. Lange, Lerner and other neoclassical market socialists thought these conditions could be met simply by announcing to managers that they had to meet these objectives, but Hayek countered that the marginal conditions are not assumptions that go into a market process, but results that emerge out of the competitive market process as actors actively learn and discover the best way to pursue their plans through time. See Lavoie (1985) for a thorough treatment of the controversy over market socialism.

In two popular biographies of Hayek, Ebenstein has argued that Hayek's research program in economic theory has proven to be unproductive, but that his research program in law, politics and social philosophy grapples with the deepest and most fundamental problems in political philosophy. (Ebenstein 2001: 223) Ebenstein even argues that *Law, Legislation and Liberty* must be ranked as "one of the greatest works in political philosophy of the twentieth century" (Ebenstein 2003: 187).

We see a strange connection between the criticisms of Posner and those of Ebenstein. While Posner appreciates Hayek's economic arguments about the price system, he thinks his legal theory is overly restricted and ultimately disconnected from economic reasoning. On the other hand, Ebenstein thinks Hayek's work in technical economics (namely monetary and capital theory) is hopelessly confused and unconnected to his later work.<sup>10</sup> What we have tried to argue is that Hayek's early work on capital and imputation theory led him to delve deeper into the problem of the coordination of economic activities through time. This led him naturally from interest rates, to monetary transmission mechanisms, to the price system at large, and finally to the political and legal institutions within which the price system is embedded.

Posner sees Hayek's economics as fine, though not rigorous, but his legal theory flawed, Ebenstein sees Hayek's technical economics as flawed, but his legal theory as fine. They criticize Hayek from different angles, but both attempt to divorce his economics from his legal analysis. It is our conjecture that both Posner and Ebenstein are led to dismiss the connection between Hayek's economics and legal theory because they fail to appreciate the complexity of economic coordination that exists in a market society.

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<sup>10</sup> As a piece of evidence he quotes from Milton Friedman saying that one of the reasons the economics department at the University of Chicago didn't offer Hayek a position was that they disagree with his economics. It was Hayek the author of *Prices and Production*, not Hayek the author of *The Road to Serfdom* that was rejected. (Ebenstein 2001: 174) Ebenstein sides with the Chicago school against Hayek not only in the areas of monetary and capital theory, but also with regard to epistemology.

Of course, this failure is due in large part to the success of the price system within western societies to solve the problem of intertemporal coordination. Precisely because it works so well, we tend to take it for granted. This was, of course, an argument Hayek would use again and again in his debates with western intellectuals over socialism. Intellectuals were led into a “fatal conceit” precisely because they took for granted the institutional heritage they inherited and which had made their lives so comfortable. Hayek came to recognize this fatal conceit in others because of his engagement in the socialist controversies. In the original aspiration of its adherents, socialism was supposed to be what liberalism was not. Where liberalism required private property, socialism would abolish private property and rely on collective ownership; where liberalism utilized the price system and production for profit to guide resource use, socialism would substitute central planning and eliminate the anarchy of production with rationalized production for direct use; where liberalism enabled the exploitation of man by other men and an unequal distribution of power and financial resources, socialism would eliminate exploitation and pursue egalitarian goals to ensure social harmony. In short, to be engaged in this debate Hayek was drawn into thinking about the foundational issues associated with a market economy.

By delving deeply into an analysis of alternative institutional arrangements, Hayek started to appreciate how tenuous the promise of material progress was, and also, ironically, how once certain institutional patterns were adopted the system was robust in the face of deviant behavior. Grounded in a neoclassical model of perfect coordination, Posner and Ebenstein both tend to downplay the intricate mix of institutions that enable social order. Posner is forced into a situation where the Judge (not the politician) takes on the stance of Adam Smith’s man of systems and tries to maneuver men as so many

pieces in a chess game.<sup>11</sup> Ebenstein resists the intellectual allure of the man of systems associated with large-scale social engineering, but since he pushes aside the technical economics which underlie the critique of such exercises he is left with a string of assertions for the liberal society. The intimate connection between liberal institutions and the market economy they enable is not explored.

Instead we get three separate arguments in his presentation – a technical economic argument which is rejected, a meta argument about decentralized price mechanism, and a moral philosophy argument about freedom – but the connection between these arguments is not made. Hayek's work on the efficiency of the price system is recognized, though Ebenstein rejects Hayek's capital theory and work on the monetary theory of the trade cycle even though it is but one application (all be it a major one) of the general point about the use of knowledge and the coordination of plans through time. The interconnectedness of these contributions is not acknowledged by Ebenstein. But we contend that unless one appreciates the delicate nature of the capitalist structure of production, the acute problems that socialism faced in terms of rationally allocating resources will be minimally understood. The incentive problems the socialist economic system faces might be recognized, but the problems of rational economic calculation will not necessarily be recognized.

And herein lies the connection between Posner and Ebenstein.<sup>12</sup> Despite both their general skepticism toward government control of economic life and their commitment to the power of markets to marshal self-interest to generate efficiency and social order, they don't explore how markets and the institutional infrastructure within

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<sup>11</sup> See Smith (1759: 233-234) for his discussion of the man of systems.

<sup>12</sup> The fundamental problem is one of the conceptions of a capitalist economy and the differences in this regard between a Knightian or Chicago view and a Misesian or Austrian view. The crucial differences in this vision and the implications for economic theory are discussed in Boettke and Vaughn (2002).

which markets are embedded actually solve the social dilemma of generating social cooperation among heterogeneous actors in a world of uncertainty and imperfect human beings. Hayek's research program in economics and political economy was one which sought to pursue the full implications of, as O'Driscoll and Rizzo (1985) so aptly titled their book, the economics of time and ignorance. In such a world the market task of meshing the production plans of some with the consumption demands of others become an intricate process of learning and adjustment guided by signals such as interest rates, relative prices and profit and loss accounting. Also in such a world, the role that political, legal and social institutions play in framing this process of learning and adjustment takes on a necessary urgency they don't in the institutionally antiseptic neoclassical theory of rational agency where the behavioral postulates in the intellectual framework do all the heavy intellectual lifting.

#### **4. Conclusion**

This paper has been an attempt to defend Hayek's legal theory against recent criticisms. As we have maintained throughout this paper, truncating Hayek's research program and looking at one part in isolation serves to fundamentally distort the aim of the program in its entirety. Hayek's work as a whole provides readers with many important and profound insights. When reading Hayek, one cannot separate his understanding of an economic system from his understanding of legal and political systems.

Both Richard Posner and Alan Ebenstein have drawn incorrect conclusions from Hayek's work. Posner argues that Hayek must be promoting a different type of economics because at the end of the day Hayek is unwilling to allow judges to engage in law creation. But, as we have shown, Hayek essentially agrees with Posner on the laws

of economics. The disagreement is one over the role the economist should have in the legal system and the economy more generally. Hayek demands a certain restraints on legal change because individuals within a social system are attempting to cope with uncertainty and ignorance and the relative permanency of the law serves as a nodal point of orientation that enables social cooperation among actors.

We have argued that Ebenstein also fails to appreciate the power and complexity of Hayek's argument. It is hard to see how anyone can appreciate the subtle argument Hayek makes for the institutions of a liberal society unless they see the consistent emphasis in his work on the theme of the coordination of diverse plans as the key to social order. Hayek's essentially epistemic argument in *The Constitution of Liberty* and *Law, Legislation and Liberty* for the rule of law and the generality norm in particular makes sense only if one appreciates the complexity of the task of coordinating economic activities through time and among the multitudes of actors (each with a multiplicity of preferences to be satisfied). This social cooperation must be accomplished for the most part among anonymous actors and not close friends, and by individuals who imperfectly come to know opportunities for mutually beneficial exchange and who only dimly perceive future opportunities for mutual benefit. Yet liberal societies realize these gains from exchange, whereas illiberal ones either squander them or leave unexploited and the reason for this is that liberal societies rely on the market institutions of money prices, and the monetary calculation of profit and loss.

In conclusion, we have argued that the Hayekian legal theory that stresses the need for simple rules follows directly from the Hayekian economics of complex coordination in a world of uncertainty and human ignorance.

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