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Hayek's new ideas and present-day ones

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Abstract This paper reexamines key themes in Friedrich Hayek's work, including his early macroeconomics and work on overinvestment, as well as his critiques of socialism and corporatism. The paper argues that Hayek's concern was over economic efficiency rather than innovation. Hayek viewed innovation as exogenous to the business sector, as did Schumpeter. A likely reason for his resistance to innovation as indigenous to the business world was his unease about a theory of the capitalist economy in which the future is indeterminate. Viewing innovation as rare and exogenous helped to minimize the problem of indeterminacy in his economic model. While Hayek's great ideas will continue to be revered, economic scholarship must now build an economics that gives central place to indigenous innovation in determining a modern economy.

Keywords Adaptation · Indeterminacy · Overinvestment · Socialism · Corporatism · Exogenous innovation

JEL Code · B2 · B3

While adulated by many, Friedrich Hayek is no longer read at all widely in the economics profession. In the minds of many, perhaps most, *scholars* of economic thought, however, he is one of three main pioneers of modern economics, alongside Frank Knight and John Maynard Keynes.

I will comment on a half-dozen of the themes sounded or puzzles raised in Hayek's work.

1. Hayek's early macroeconomics remains strange to most economists.

    - Hayek's belief that a cutback decrease in the supply of saving would soon *contract* employment – contrary to Keynes's view – was not corroborated from

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macro data. The problem is that Hayekian effects cannot be discerned in the haze of Keynesian effects working in the opposite direction. In a neo-Austrian model such as the one that Hian Teck Hoon and I built, it is theoretically possible that a stimulus to consumer demand, in altering long-term expectations of future asset prices, would reduce present asset prices, thus reducing investment activity and contracting aggregate employment (Hoon and Phelps 2008).

- Hayek's belief that a miscalculated rise of the capital stock – the famous "over-investment" – would also depress asset prices and employment has not found empirical support either, though Hian Teck has argued that it is theoretically valid. (The difficulty to be met is that interest rates fall, which forces the real price of the capital good to *rise*, not to fall!)

2. Hayek's criticism of socialism, including what Oskar Lange called "market socialism," is fundamental to economists' belief that, with a class or two of exceptions, the allocation of resources is best left to private enterprise – to private actors having the autonomy to take initiative and responsibility, and thus to create and innovate (Lange 1936).

   - Yet it is a mistaken reading of Hayek's classic papers on this subject, from those dating from the mid-'30s to the 1945 paper on the "uses of knowledge," to portray them as arguing that socialism cannot generate *innovation* and capitalism can (Hayek 1945). He was far from articulating any such thing. Hayek never discusses what I have taken to calling *indigenous innovations*in the business sector. He writes about what he calls "adaptations" to "changing circumstances" in the economy or in the outside world. He sees the business person aswell situated to spot new opportunities that have arisen.

3. Toward the end of this period from the early '30s to the mid-'40s, Hayek saw another threat to capitalism. Those who have not read the book suppose that his 1944 work *The Road to Serfdom* is yet another argument against socialism (Hayek 1944). But as Hayek said himself in a preface, the book is a warning to Britain not to adopt the *corporatism* that came to grip Germany, Austria, and Italy in the 1920s and 1930s. Hayek was explicit that he did not oppose all government spending: for example, he favored investing in medical research aimed at extending human longevity. Keynes, in his congratulatory letter to Hayek, wrote that he too wanted to see a number of government initiatives but his list of sanctioned roles for the state was quite different from Hayek's (Keynes 1971). (Mine are different from both.)

   The critique in *Road* is essentially that corporatist government blocks businesses from some avenues and even pushes them into other avenues; this insidious interference tends to grow until economic performance is seriously damaged. As in the works of the '30s, the concern is over economic efficiency, not innovation. (The companion critique by the late Mancur Olson is that the corporatist state hands out patronage to all the special interest groups with the result that the tax burden exceeds the benefit for everyone (Olson 1965)).

   In fact, it is not clear Hayek thought that Nazi Germany was particularly damaging to innovation. He appears simply to have had a feeling that private business would suffer increasingly under the Nazis, whatever economic successes the Nazi government had.

4. To my knowledge, the notion of innovation *indigenous* to a nation's economy, particularly its business sector, is not to be found in Hayek's writings. Yet he discusses aspects of "economic change" – to use Richard Nelson's term – in his scintillating comment on John Kenneth Galbraith's work, "The *Non Sequitur* of the 'Dependence Effect,'" published in 1961 in the *Southern Economic Journal* (Nelson and Winter 1982). There Hayek points out that the widespread audience for the highly original books of C.P. Snow, let alone the writing and the publishing of them, could not have been predicted. Hayek's theme is that there is radical uncertainty over how genuinely new products will be received in the marketplace.

   In Hayek's 1961 view, the creativity of an artist or inventor occasionally offers entrepreneurs the opportunity to offer a novel product to the market – an opportunity that will be seized if one or more of them judge it is worth taking a chance on the new thing. In Schumpeter's 1912 book on "economic development," the occasional discoveries by explorers and scientists open up "obvious" opportunities for the unimaginative people who supply the entrepreneurship (Schumpeter 1934). Thus both Hayek and Schumpeter did not see the business sector as possessing imagination or creativity. (It is interesting Hayek's example, C. P. Snow, was both a novelist and a scientist.)
5. Why did Hayek resist thinking of the business world as a ferment of creative minds keen on innovating and, absent barriers, achieving a powerful flow of innovations? A likely answer is that he would have felt uneasy about a theory of the capitalist economy in which the future is *indeterminate.* Oskar Morgenstern complained in 1935 of a contradiction in the way that Hayek was portraying a significantly innovative capitalist economy: On the one hand, he introduced into his model entrepreneurs who eradicated inefficiencies (Morgenstern 1976). That led Hayek to describe the economy of his model as maintaining efficiency, hence not going off on any errant paths – not ever in disequilibrium. On the other hand, he admitted into the model structural shifts brought about by innovations, which, being generally unforeseeable, could not be governed by known or even knowable stochastic processes. So the Hayekian model was an economy with an indeterminate future. But that model meant that the investment decisions made by entrepreneurs could not be efficient, or Pareto-optimal; and the entrepreneurs could not be supposed to follow unerringly an equilibrium path. The entrepreneurs would have no way of really knowing where best and how much to invest. They would have to employ their judgment and engage in guesswork. Hayek never brought out that feature of the model he sketched. He could minimize the problem by viewing innovations as rare and having generally modest consequences.
6. This leads to my work in the past 10 years or so on the conditions for innovations to be chronic and abundant; and on its human value. In my recent book, *Mass Flourishing*, I argue for replacing the view of innovation as largely exogenous to the entrepreneurs and employees of the business sector, which is held by Schumpeter and Hayek, with the view that innovation is largely *indigenous* to the economy, the fruit of people working in business. Let me quote from a succinct statement:

> …[T]he indigenous innovation of a country is fueled by the people's imagination and creativity… But – the key step – this fuel has to be sparked by the

"dynamism" in the economy – the *desire* of people to attempt innovation, peoples' *capabilities* at innovating, and the *latitude* society gives to innovators. If this dynamism runs widely over the economy – pervading all or most industries – and if it runs deep – down to the grassroots of the society – the force of this dynamism will be powerful.

The rewards of such economy are profound. The most valuable rewards are non-material. Workers are engaged and challenged. Careers become voyages of creation and discovery. Even for ordinary people, working life can be hugely meaningful (Phelps 2014. Acceptance Speech at the ceremony for presentation of the China Friendship Award, Beijing, 29 September).

While we continue to revere the great ideas in Hayek alongside those of Knight and Keynes, we must get on with the task of building an economics that gives a central place to indigenous innovation – its presence or absence, its rise or decline – in determining practically everything we care about in a modern economy.

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