

Why We Still Need to Read Hayek

John B. Taylor¹

The Hayek Lecture
May 31, 2012
New York City

It is an honor to receive the Hayek Prize for *First Principles* and a special pleasure to give the Hayek Lecture. The first piece by Hayek I read was his famous paper “The Use of Knowledge in Society,” published in the *American Economic Review* in 1945.² It’s a beautiful paper, showing why economic prosperity is best achieved by letting individuals interact together using their unique knowledge sets which people at the top do not have. It is the same paper that Matt Ridley focused on in last year’s Hayek Lecture. I recall reading this paper as a college student, but I have re-read it many times, and I still recommend it.

But today I want to focus on another part of Hayek’s work, a part that I came to appreciate much later, after years of research and experience with economic policy. This is his work on policy rules, the rule of law, and the importance of predictability—topics he discusses in *The Road to Serfdom* and in much more detail in *The Constitution of Liberty*. I have been interested in policy rules or strategies as a way to make policy for as long as I have been doing economics. I was drawn to this way of thinking because of the kind of dynamic economics I was first taught in college, originally by a young assistant professor E. Philip Howrey. As I will show in this lecture, Hayek’s work on these topics goes well beyond economics into fundamental issues of freedom and the role of government. And that is why we need to keep reading Hayek.

First Principles and the Need for a Concrete Reform Strategy

Let me begin with *First Principles*. It is becoming increasingly apparent that America’s economic future is uncertain. The economy is growing slowly. Unemployment is high, especially long-term unemployment. We have just gone through a painful financial crisis and a deep recession, the recovery from which is nearly nonexistent. The federal debt is exploding and threatening our children and grandchildren. In my view the reason for this predicament is very clear: We have deviated from the first principles of economic freedom upon which America was founded.

As Hayek would insist, we need to be careful about what we mean by economic freedom. The basic idea is that people are free to decide what to produce, what to buy, where to work, how

¹ I thank the Manhattan Institute, the Hayek Prize Committee, and Drake McFeely, Brendan Curry, and Donald Lamm who were responsible for publishing *First Principles: Five Keys to Restoring America’s Prosperity* (Norton 2012) which won the Hayek Prize. It is also a special pleasure to return, with my wife Allyn, to Manhattan, our first home and the birthplace of our children, to give the Hayek Lecture.

² Hayek, F.A. (1945), “The Use of Knowledge in Society,” *American Economic Review*, 35, 4, September, pp. 519-39. Reprinted in F.A. Hayek, *Individualism and Economic Order*, University of Chicago Press, Chicago, 1948.

to help others. The American vision was that they would make these choices within a *predictable policy framework*, based on the *rule of law*, with strong *incentives*, emanating from a *reliance on markets*, and a *clearly-limited role for government*. Over the years America has adhered to these principles more than most countries. That's a big reason why so many people came to America, and why it has prospered as a nation.

But there have been ebbs and flows in the degree to which the principles have been followed, and we can learn from these ebbs and flows. Leading up to the Great Depression, policy deviated from a reasonably predictable policy framework, as the Fed cut money growth sharply. Then the federal government raised tax rates and tariffs, and went well beyond sensible limits on government and the rule of law in the National Industrial Recovery Act which overrode many market principles.

There's even more evidence in the past half century. From the mid-1960s through the 1970s, policy deviated from the principles. There were unpredictable short-term stimulus packages, discretionary go-stop monetary policies, and wage and price controls—the anathema of a market system based on incentives. The results were terrible: double digit unemployment, double digit inflation, and a marked slowdown in economic growth. Hayek's view about such short-termism was quite clear. He wrote “I cannot help regard the increasing concentration on short-run effects...not only as a serious and dangerous intellectual error, but as a betrayal of the main duty of the economist and a grave menace to our civilization.”³

Then America moved back toward first principles in the 1980s and 1990s, and until recently. Temporary stimulus programs were out. Permanent tax reform was in. Steady as you go monetary policy replaced go-stop monetary policy. The last vestiges of price controls were removed and inappropriate regulations were reduced. The major federal welfare program was moved to the states. The result was declining unemployment, lower inflation and eventually a revival of economic growth.

But now we have tragically deviated again. Leading up to the crisis, monetary policy deviated from the rules-based policy that worked in the 1980s and 1990s by holding interest rates too low for too long. Government regulators failed enforce existing rules on banks or other financial institutions, including Fannie Mae and Freddie Mac. And then the crisis came, along with the Wall Street bailouts, which soon crept beyond their original mission to bailout automobile companies, resulting in arbitrary deviations from the rights of creditors and interventions into the operations of businesses.

Then came the return of the failed stimulus packages of the 1970s, the Fed's quantitative easing, and the regulatory uncertainty associated with 2010 health care legislation and Dodd-Frank financial reform bill, which gives government the discretionary authority to take over any failing financial firm and rescue its creditors.

³ Hayek, F.A. (1941) *A Pure Theory of Capital*, 1941, Macmillan, London. Reprinted in *The Collected Works of F.A. Hayek, Volume 12*, Lawrence H. White (Ed.), University of Chicago Press, Chicago, 2007, p. 368.

We have some numerical measures of the increase in policy uncertainty. The number of provisions of the tax code expiring each year has skyrocketed from 11 in 2000-2002 to 133 in 2010-2012. The number of federal workers engaged in regulatory activities (excluding the Transportation Security Administration) has grown by 25 percent from 2007 to 2012. The epitome of the deviations from basic principles is the self-inflicted fiscal cliff where virtually the entire tax code changes at the end of this year. And the Fed has effectively replaced the money market with itself and set a zero-interest rate policy through 2014. Overall, economic performance has been very poor.

However, because government policy has been the cause of the problem, we can get back to prosperity by changing the policy. Indeed, a concrete and workable plan follows directly from the principles. It consists of (1) bringing federal spending as a share of GDP to what it was in 2007, which will mean the budget can be balanced and the debt explosion can be stopped without an increase in taxes and with a revenue neutral pro-growth tax reform; (2) unwinding the monetary excesses and normalizing monetary policy with a rules based system of the kind that worked well in the 1980s and 1990s; (3) halting the rapid expansion of the entitlement state by keeping entitlement spending growth close to GDP growth and do it in a way that gives key decision making responsibility to individuals and states rather than to the federal government; and (4) replacing most of the Dodd Frank bill with a reformed bankruptcy law and simpler regulations that have the goal of ending government bailouts. My book *First Principles* explains in simple terms why this kind of strategy will work.

Now let me focus on why policymakers need Hayek's help to reinforce these ideas and implement the strategy.

First note that two of the five principles of economic freedom—the rule of law and policy predictability—have not been stressed as much in economics as have been the other three—markets, incentives, and a limited role of government. That is why I put these two at the top of my list. But both are big themes of Hayek. He wrote in *The Road to Serfdom*, that “nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.”⁴

The Dual Case for the Rule of Law: Freedom and Prosperity

I have emphasized in my research that more rules-based policy lead to a more stable economy with more sustainable economic growth, and there is much empirical and theoretical evidence for this. When people make decisions they look ahead to the future. Prices which convey information and provide incentives reflect the future. So both good decisions and the

⁴ Hayek, F.A. (1944) *The Road to Serfdom*, University of Chicago, Chicago. Reprinted in *The Collected Works of F.A. Hayek, Volume 2*, Bruce Caldwell (Ed.), University of Chicago Press, Chicago, 2007, p. 122.

prices which guide them depend on the predictability of future policy and thus on clear policy rules. Rules-based policies promote a more prosperous economy.

But Hayek emphasized that rules for government policy do something more. The rule of law protects freedom, an idea that is conveyed in the very title of Hayek's *The Constitution of Liberty*. Hayek traces this idea through the ages, first to Aristotle, then to Cicero, about whom Hayek writes "No other author shows more clearly...that freedom is dependent upon certain attributes of the law, its generality and certainty, and the restrictions it places on the discretion of authority,"⁵ and then to John Locke, who he quotes as saying "The end [meaning the purpose] of the law is, not to abolish or restrain, but to preserve and enlarge freedom...where there is no law there is no freedom,"⁶ and ultimately to James Madison and other Americans who put the ideas into practice in a new nation.

These writers distrusted the power of government officials as a means of protecting and preserving freedom. In the classic dichotomy of rules versus authorities, they viewed rules as less arbitrary. The rule of law brought individual freedom.

So rules have a dual purpose and they are supported by two different constituencies—those interested in freedom and those interested in economic prosperity.

There is probably no better way to understand the dual advantages of rules than to examine what happens in their absence, as in the case of wage and price controls. Controls are arbitrary, requiring decisions by people at the top about virtually every price and wage. They also screw up the economy, distorting signals and incentives and creating shortages and surpluses. This occurs whether the price controls are on the whole economy or on a major part of the economy such as health care.

Rules Don't Mean You Don't Do Anything

I am frequently asked how a system of policy rules can work in practice when politicians and government officials are so often called on to "do something, anything," and feel strong pressure to do so. Rules sound good, skeptics say, but rules mean you do nothing, and that is impossible in today's charged political climate and hour to hour or even minute to minute news cycle, you have to be more flexible. My colleague George Shultz describes the problem as "the urge to intervene" when he describes events where, as a policy maker, he resisted that urge.

Hayek had an answer to this question. In *The Road to Serfdom* he pointed out the need to clear up a "confusion about the nature of this system [of formal laws or rules]: the belief that its characteristic attitude is inaction of the state" and noted by way of a counter example that "the

⁵ Hayek, F.A. (1960), *The Constitution of Liberty*, University of Chicago Press, Chicago. Reprinted in *The Collected Works of F.A. Hayek, Volume 17*, Ronald Hamowy (Ed.), University of Chicago Press, Chicago, 2011, pp. 245-246

⁶ Hayek, F.A. (1960), *The Constitution of Liberty*, University of Chicago Press, Chicago. Reprinted in *The Collected Works of F.A. Hayek, Volume 17*, Ronald Hamowy (Ed.), University of Chicago Press, Chicago, 2011, p. 232.

state controlling weights and measures (or preventing fraud or deception in any other way) is certainly acting....”⁷

Consider some other examples. Simple rules for monetary policy do not mean that the central bank does not take action to change the instruments of policy (interest rates or the money supply) in response to events, or to provide loans in the case of a bank run. Rather it means that they take such actions in a predictable manner. And inaction can mean that one has deviated from a rule or a strategy. A decision by government regulators, for example, not to act when financial institutions take on risk beyond the limits of the rules and regulations is inaction and certainly is not observing the rule of law. It is important for policymakers to be able to explain that a policy strategy involves a series of actions.

Some claim, especially in the case of the recent crisis, that crises force policy makers to deviate from rules and the rule of law. But a crisis may be the worst time to deviate from rules. In a crisis, increased clarity about the strategy rather than increased unpredictability is needed. This was clear following the first bailout of the recent crisis—the Bear Stearns intervention, when few knew what to expect the next time because no strategy was put forth. So the crisis got worse. The sooner people can make their decisions with knowledge of the rules, the sooner recovery from a crisis will come.

Who Gets Us In And Out Of These Messes?

What can we do as citizens to help America get back to the principles of economic freedom and stay there? We have to choose leaders who believe in the principles and know how to implement them, and we have to look for laws and rules which will incentivize leaders to follow such principles. But here Hayek issued a warning. In his pejoratively-titled chapter “Why the Worst Get on Top?” in *The Road to Serfdom*, he argues that there is a bias against such individuals taking such positions of leadership. People who have the ambition to get to the top, either by election or by appointment, frequently have a bias toward activism or doing whatever it takes. Interventionists will thus tend to rise to the top. And when they reach high positions these biases can be reinforced, as regulatory capture, crony capitalism, and the promise of further advancement set in.

Those in society who benefit directly from discretionary government interventions have incentive to help officials who favor such interventions advance. Industries and firms that benefit from bailouts will favor officials who are comfortable with bailouts. Even academic research on economic policy will become biased toward such interventionism. Perhaps the answer to Hayek’s warning is to look for people who are viewed as “overly committed” to principles economic freedom. Then, after experiencing the heavy pressure pushing them toward abandoning the principles, they may come out with a sensible balance. In the 1980s Ronald Reagan appointed many people who had PhDs in economics from the “Chicago school of thought” to positions of economic leadership.

⁷ Hayek, F.A. (1944), *The Road to Serfdom*, University of Chicago Press, Chicago. Reprinted in *The Collected Works of F.A. Hayek, Volume 2*, Bruce Caldwell (Ed.), University of Chicago Press, Chicago, 2007, p. 118.

Keynes had a much different view. In a famous letter to Hayek about *The Road to Serfdom*, Keynes expressed his preference for more interventionist appointees, but he wanted only *beneficent* interventionists. Keynes wrote: “I should therefore conclude your theme [in *The Road to Serfdom*] rather differently. I should say that what we want is not no planning, or even less planning, indeed I should say we almost certainly want more. But the planning should take place in a community in which as many people as possible, both leaders and followers, wholly share your own moral position.”⁸ Milton Friedman later used this letter from Keynes to Hayek to illustrate the key defining characteristic of Keynesian policy—its focus on discretionary interventions taken by people in powerful government positions—with too little concern for Hayek’s warning about who would actually wind up in those positions.⁹

Even those who support the principles of economic freedom can sometimes get off track. One can argue that such deviations were needed in the panic of the fall of 2008, and perhaps they prevented a more serious panic. But that it is like saying that the person who set fire to a house should be exonerated because he helped put out the fire and saved a few rooms.

During the economically turbulent 1970s, Hayek himself¹⁰ seemed to say that discretion in monetary policy was needed, and others began saying the same thing.¹¹ But the objection to this view from Milton Friedman was loud and clear; he sent a letter to Hayek in 1975 saying: “I hate to see you come out as you do here for what I believe to be one of the most fundamental violations of the rule of law that we have, namely discretionary activities of central bankers.”¹²

How Serious Is the Assault on Economic Freedom?

Is today’s departure from economic freedom, as I describe it here and in *First Principles*, any less serious than the assault on freedom that Hayek famously wrote about in *The Road to Serfdom*? Am I exaggerating when I say the future of American prosperity is at stake? Or even that the future of world prosperity is at stake if America has to back off its leadership position?

While central planning may not be the right word now, consider the new health law in which the terms of everyone’s health insurance package will be mandated by the federal government and in which an Independent Payment Advisory Board will determine the price, quantity, and quality of each type of medical service that a medical professional provides, from

⁸ Keynes, J.M. (1944), Letter to F.A. Hayek, June 28, 1944. Hayek Papers, Hoover Institution Archives, Stanford, California.

⁹ Friedman, Milton (1997), “John Maynard Keynes,” *Economic Quarterly*, Federal Reserve Bank of Richmond, Spring, Vol. 83, No. 2, pp. 1-23.

¹⁰ Hayek, F.A. (1975), *Full Employment at Any Price?* Institute of Economic Affairs, London, p. 28.

¹¹ For example, monetary economist David Laidler argued at the Annual Bank of Japan International Conference in 1991 that “We are left, then, with relying on discretionary policy in order to maintain price stability,” which was a motivation for me to work on a practical rule for monetary policy that eventually became known as the Taylor rule.

¹² Friedman, Milton (1975), Letter to F.A. Hayek, September 11, 1975. Hayek Papers, Hoover Institution Archives, Stanford, California.

number of MRIs to the necessary accuracy of CT scans. Is that so different from determining the price, quantity, and quality of livestock, wheat, or steel that can be produced under central planning?

And consider monetary policy. A few years ago, I coined the term “monustrial policy” to convey the idea that the Fed’s quantitative easing policy was a combination of industrial policy—discretionary assistance to certain firms and industries—and monetary policy—printing money to finance that assistance. Since then the Fed purchased \$1.25 trillion of mortgage backed securities, and in fiscal year 2011 it purchased 77 percent of the newly issued federal debt, long after panic conditions subsided.

Conclusion

I have argued in this lecture that by moving away from the basic principles of economic freedom, government policy has become the source of our recent economic problems. It should be no consolation that some of our friends in Europe are having worse economic problems. Indeed, many of them moved even further away from these principles.

The good news is that a change in government policy will alleviate these problems and restore economic prosperity. I have faith that we will turn things around, but we clearly have not done so yet, and it will be difficult. Paying attention to what Hayek wrote in similar circumstances in the not so distant past will help greatly.