

Feld, Lars P.; Nientiedt, Daniel

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Hayekian Economic Policy

Lars P. Feld und Daniel Nientiedt

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Hayekian Economic Policy

Lars P. Feld

University of Freiburg and Walter Eucken Institut

Daniel Nientiedt

New York University

Abstract:

What is the appropriate role of the state in economic policy-making? This paper shows that Friedrich Hayek, who is often considered a proponent of *laissez-faire* liberalism, offers three different answers to this problem. First, Hayek argues that the state should provide a legal framework for competitive markets. Second, he proposes to employ the rule of law criteria – generality, equality, and certainty – to distinguish permissible from non-permissible state interventions. Third, he rejects deliberate legislation and moves closer to the Misesian idea of a minimal state. The paper considers these answers in light of Hayek’s analysis of the knowledge problem. We suggest that a Hayekian approach to economic policy-making should focus on improving the framework of general rules that guide individual behavior, thereby enabling spontaneous ordering processes and reducing the epistemological burden placed on policy-makers.

Keywords: Friedrich Hayek; Rule-based economic policy; Spontaneous order; Knowledge problem; Cultural evolution

JEL classification: B31; D78; P16

Corresponding author: Prof. Dr. Dr. h. c. Lars P. Feld, Walter Eucken Institut, Goethestr. 10, 79100 Freiburg im Breisgau, Germany, feld@eucken.de

Hayekian Economic Policy

1. Introduction

Friedrich Hayek¹ is often viewed as a quintessential proponent of *laissez-faire* liberalism, i.e., the conviction that markets should be largely unregulated by the state (Bowles et al., 2017; Samuelson, 2009). Indeed, those who hold this conviction today regularly invoke his writings as a justification (see, e.g., Farrant and McPhail 2010, pp. 97–98). To be sure, Hayek’s work has important implications for the question as to what economic policy can (and should attempt to) achieve. However, as shown by this paper, his work contains three different accounts of the proper scope of economic policy, only one of which could be classified as *laissez-faire*. The paper then considers these accounts in light of Hayek’s broader oeuvre and proposes a specifically Hayekian approach to economic policy-making.

In the 1930s and 1940s, Hayek was part of the emerging neoliberal movement.² The neoliberals agreed with the liberal thinkers of the 19th century on the importance of individual freedom as a political value. But they questioned whether a policy of *laissez-faire* would bring about a desirable economic system. They particularly argued that the state needed to play a more active role in creating and maintaining competitive markets.

The neoliberals’ position immediately leads to the question as to what exactly the state should do to uphold competition. The positive agenda of governmental intervention was the subject of works such as Henry Simons’ *A Positive Program for Laissez Faire* (1934), Walter Lippmann’s *The Good Society* (1937), Lionel Robbins’ *Economic Planning and International Order* (1937) and Walter Eucken’s *Grundsätze der Wirtschaftspolitik* (1952).

¹ For an overview of Hayek’s life and work see Caldwell (2004).

² The term neoliberalism was coined by Alexander Rüstow at the Walter Lippmann Colloquium of 1938 to demonstrate distance to classical liberalism (Reinhoudt and Audier, 2018). Only later during the Thatcher and Reagan governments in the UK and the US respectively did the term become an expression of political activism.

Already in his inaugural lecture at the London School of Economics, Hayek emphasized the “positive part of the economist’s task, the delimitation of the field within which collective action is not only unobjectionable but actually a useful means of obtaining the desired ends” and referred to the problem of determining the scope of economic policy as “one of the main tasks of the future” (Hayek, 1933, p. 134). He kept working on this problem – in some form or another – for the rest of his career.³

Despite this commitment, Hayek’s position on the appropriate role of the state in economic policy-making is surprisingly difficult to pin down. To some extent, this is certainly the result of changes in his thinking across time. As noted above, the literature often suggests that Hayek should be seen as a proponent of *laissez-faire* liberalism rather than a reformer of liberalism. Other accounts highlight his view that legitimate state action must conform to the rule of law (Barry, 1979; Boettke, 2018). As will be shown in the paper, both descriptions can be justified. However, they don’t do justice to the full complexity of Hayek’s position.

Following the distinction put forward by Ulrich Witt, economic policy can be discussed from three different perspectives. The discussion can focus on 1) the political economy of actual policy-making, 2) the analysis of policy instruments for given ends, or 3) policy goals and their legitimization (Witt, 2003, p. 78). In this paper, we will mostly be concerned with Hayek’s views on the second topic, i.e., the question what economic policy could do. The issue of legitimacy will be important only insofar as Hayek’s policy proposals are based on the value of individual freedom. Less attention will be paid to the process of policy-making.⁴

³ Most of Hayek’s remarks on economic policy are theoretical in nature. One exception is a set of reports which he produced for the government of Gibraltar in 1944 and in which he suggested to reorganize Gibraltar’s struggling housing market according to free market principles. This recommendation was seemingly at odds with Hayek’s usual emphasis on personal liberty, as it could have led to the relocation of residents into Fascist Spain (Grocott, 2015).

⁴ The analysis of the process of policy-making is central to the Public Choice movement starting with the early works of James Buchanan (e.g., Buchanan, 1954).

The paper is organized as follows. Sections 2 to 4 describe the evolution of Hayek's views on economic policy. It will be shown that, over the course of his career, he answers the question of what economic policy could do in three different ways. Section 5 compares these answers to Hayek's larger body of work and develops a specifically Hayekian approach to economic policy-making. Section 6 concludes with a summary and additional remarks.

2. Planning for Competition

Hayek's first substantial account of the appropriate scope of economic policy can be found in the 1939 pamphlet *Freedom and the Economic System*. Here, he distinguishes between two kinds of economic planning. The term may refer to the centralized direction of the economy, as in Soviet Russia. But it may also refer to what Hayek calls "the construction of a rational system of law" (Hayek, 1939, p. 9):

We can "plan" a system of rules, equally applicable to all people and intended to be permanent (even if subject to revision with the growth of knowledge), which provides an institutional framework within which the decisions as to what to do and how to earn a living are left to the individuals. In other words, we can plan a system in which individual initiative is given the widest possible scope and the best opportunity to bring about effective coordination of individual effort. (Hayek, 1939, pp. 8–9)

Hayek notes that the liberals of the 19th century vindicated "on utilitarian grounds" (Hayek, 1939, p. 11) the general principles of private property and freedom of contract but failed to extend this criterion to specify the content of the necessary legal rules.⁵ In his opinion, this failure brought the whole liberal doctrine into discredit (Hayek, 1939, pp. 11–12).

The deliberate construction of a system of rules is expanded upon in *The Road to Serfdom*, where Hayek refers to this task as "planning for competition" (Hayek, [1944] 2007, p. 90). In Hayek's view, the state – or the government, as he often says – has "obvious tasks" to foster economic

⁵ In his address to the first meeting of the Mont Pèlerin Society, Hayek provides some examples as to why these principles are insufficient (Hayek, [1947] 1948, pp. 113–116).

activity, most importantly the handling of the monetary system and the prevention of monopoly power. Hayek also speaks of “less obvious” tasks in fields where state intervention has ambiguous effects (Hayek, [1944] 2007, p. 72).

Of the two obvious tasks, Hayek does not discuss monetary policy any further.⁶ With regard to anti-monopoly policy, he emphasizes that the coordinating function of the price system requires the working of competition (Hayek, [1944] 2007, p. 95). However, the price system is endangered by the tendency of capitalist entrepreneurs to subvert competition – sometimes with the help of the state – as well as the problem of natural monopoly. Hayek sketches a solution to this issue, namely privatization combined with stringent price controls (Hayek, [1944] 2007, pp. 205–207).

An example of a less obvious task of the state is the provision of social security. Hayek argues in favor of a guaranteed social minimum to protect people from poverty (Hayek, [1944] 2007, p. 148).⁷ Generally speaking, the scope of this category of task could be quite large. Hayek maintains that the state can intervene for three broad reasons: “To create conditions in which competition will be as effective as possible, to supplement it where it cannot be made effective” and to provide services that could not be rendered effectively to individuals (Hayek, [1944] 2007, p. 88).

The relative vagueness of Hayek’s description was criticized by John Maynard Keynes, who noted that *The Road to Serfdom* does not provide a clear criterion to distinguish permissible from non-permissible state interventions:

You admit here and there that it is a question of knowing where to draw the line. You agree that the line has to be drawn somewhere [between free-enterprise and planning], and that

⁶ In an unpublished postscript to *The Road to Serfdom*, Hayek says on the issue: “I should like to add here that I attach great importance to the fact that such a monetary policy should be guided by known rules, that in the words of the late Henry Simons the issue of ‘Rules versus Authority in Monetary Policy’ should be decided as far as possible in favour of the former” (Hayek, 1948, p. 12). We thank the estate of F.A. Hayek for permission to quote from this document. For a modern treatment of rule-based monetary policy see Boettke et al. (2021).

⁷ For details on Hayek’s position see Schnellenbach (2019). For a discussion of how welfare states incorporating Hayekian insights might look in practice see Bergh (2020).

the logical extreme is not possible. But you give us no guidance whatever as to where to draw it. In a sense this is shirking the practical issue. ... As soon as you admit that the extreme is not possible, and that a line has to be drawn, you are, on your own argument, done for since you are trying to persuade us that as soon as one moves an inch in the planned direction you are necessarily launched on the slippery path which will lead you in due course over the precipice.⁸ (Keynes, quoted in Boettke, 2018, p. 26 fn 5)

3. Legitimate State Action and the Rule of Law

As pointed out by Jeremy Shearmur (1997), Hayek's subsequent work on the rule of law can be read as a direct answer to Keynes' criticism. In an essay entitled *The Meaning of Government Interference*, Hayek first puts forward the idea that legitimate state action is defined by the fact that it conforms to the principle of the rule of law (Hayek, [1950] 2022). This criterion is also the cornerstone of the policy discussions in *The Constitution of Liberty* (Hayek, [1960] 2011).

The rule of law is a normative criterion for good law. It is a “meta-legal doctrine” (Hayek, [1960] 2011, p. 311) that is not itself a law, but rather a description of what good law looks like. Hayek names three attributes which a law must possess in order to conform to the rule of law, namely generality, equality, and certainty (Hayek, [1960] 2011, pp. 315–317). This means that the law should not discriminate in favor of or against certain persons or groups, that it should apply equally to all, and that individuals should be able to predict whether the law affects them.

How does Hayek connect this legal principle to economic policy? He argues that there are two ways in which the state may intervene in the economy: through setting up general rules of conduct – which meet the rule of law standard – or through specific instructions and prohibitions (Hayek, [1960] 2011, pp. 329–330). According to Hayek, policy measures in the form of general rules are compatible with a liberal economic system, while specific instructions are not. Policy measures in the form of general rules could still be rejected on grounds of expediency (Hayek, [1960] 2011, p. 331).

⁸ On the “slippery slope” argument at the heart of *The Road to Serfdom* see Caldwell (2011).

Note that Hayek's criterion for permissible state intervention is concerned with the method of intervention, not its volume or specific aim:

A government that is comparatively inactive but does the wrong things may do much more to cripple the forces of a market economy than one that is more concerned with economic affairs but confines itself to actions which assist the spontaneous forces of the economy. (Hayek, [1960] 2011, p. 331)

Though the rule of law is a normative principle, Hayek stresses the fact that general rules of conduct are not only good – according to the liberal political creed – but that they are also efficient. As seen in the above quote, the positive argument in favor of general rules is that they enable the coordinating principle of spontaneous order, which in turn is associated with better economic performance (Hayek, 1945).

As Hayek sees it, “the range and variety of government action that is, at least in principle, reconcilable with a free system is ... considerable” (Hayek, [1960] 2011, p. 340). Indeed, a significant part of *The Constitution of Liberty* is devoted to the discussion of various economic and social policies. In line with *The Road to Serfdom*, monetary policy is presented as a core responsibility of the state. While Hayek identifies government monopoly on money as a potential cause of inflation and contemplates the advantages of rule-based monetary policy, he concludes that there is no clear alternative to the current setup (Hayek, [1960] 2011, pp. 451–465).

In contrast to *The Road to Serfdom*, Hayek omits competition policy because he has become convinced that it does not “possess the importance commonly attached to it” (Hayek, [1960] 2011, p. 381). More specifically, he opposes discretionary competition policy, stating that private market power has only “transitory and temporary character” (Hayek, [1960] 2011, p. 383).⁹ Also omitted are the fields of fiscal and stabilization policy (Hayek, [1960] 2011, pp. 380–381).

⁹ This may be related to Hayek's view, first expressed in 1946, that competition is a dynamic process, while the equilibrium notion of perfect competition is unsuitable for regulation (Hayek, [1946] 1948b).

The rule of law criterion appears to be a straightforward way to delineate legitimate state action. In practice, its interpretation is less clear. For example, it is plausible to argue that the provision of (quasi)public goods such as roads is compatible with the rule of law criterion because they affect citizens in a similar manner (Hayek, [1960] 2011, pp. 332–333). However, Hayek also believes that the rule of law allows for publicly funded theaters (Hayek, [1960] 2011, pp. 375–376), which seems like a rather arbitrary decision in favor of a particular form of entertainment.

4. The Spontaneous Order of the Market and the Evolution of Rules

The policy recommendations of *The Road to Serfdom* and *The Constitution of Liberty* are based on the presupposition that the rule framework of economic activity is the subject of deliberate choice. In other words, Hayek assumes that the conditions under which the spontaneous order of the market comes about¹⁰ can be consciously shaped or even designed.

Hayek's position changes significantly with *Law, Legislation and Liberty* and the introduction of his theory of cultural evolution.¹¹ He now argues that market-supporting legal rules are themselves the result of a process of spontaneous ordering. This claim is contained in the distinction between two kinds of law, *nomos* and *thesis*. *Nomos* conforms to the rule of law criteria and has also developed in an evolutionary manner, while *thesis* aims at achieving particular results and is also deliberately set. A notable example of *nomos* is the English common law, which was created by judges in a case-by-case manner (Hayek, 1973, pp. 94–144).

In essence, Hayek maintains that the rule of law framework favored by him emerges spontaneously and without the need for outside intervention. While he concedes that existing rules can be

¹⁰ On the importance of a rule framework for the existence of a spontaneous order see Hayek (1964).

¹¹ At its most basic, this theory posits that the prevalence of certain rules can be explained by the fact that they contributed to the survival of a particular group. See Caldwell (2002).

improved more or less by decisions of judges or “even the occasional intervention of a legislator” (Hayek, 1973, p. 100), these kinds of improvements are secondary to the evolutionary process.¹²

If a liberal social order arises in this way, what role remains for the state? Hayek’s evolutionary theory suggests that the state cannot create the institutional conditions under which markets work best. It can merely provide services to supplement the workings of markets. There are two categories of legitimate state activity, namely the enforcement of spontaneously grown rules and the rendering of “services which the spontaneous order cannot produce adequately” (Hayek, 1973, p. 48). In terms of the categories defined above, Hayek clarifies that all state activity belongs to the realm of *thesis*, regardless of whether legislation takes the form of general rules of conduct (Hayek, 1973, pp. 126–128). Indeed, he posits that not even constitutional law qualifies as *nomos* (Hayek, 1973, pp. 134–136).

Another significant change in *Law, Legislation and Liberty* concerns the approach to monetary policy. In the third volume, Hayek recommends abolishing the government monopoly on money and replacing it with a system of privately-issued competing currencies (Hayek, 1979, pp. 57–59). For the details of this plan he refers to his then recent book *The Denationalisation of Money* (Hayek, 1978).

As for the services which the market cannot produce, this refers to the provision of public goods, and relatedly, the need to counteract negative externalities (e.g., environmental pollution). Even in his later writings, Hayek allows for this type of state activity (Hayek, 1979, pp. 41–64). He notes that this fact distinguishes him from advocates of a “minimal state” (Hayek, 1979, p. 41) such as his teacher Ludwig von Mises.¹³ However, Hayek’s remark also indicates that, at this point, his position on the scope of economic policy is actually rather similar to Mises.

¹² On the possibility that the common law may develop in a direction that is undesirable see Hayek (1973, pp. 88–89) and the discussion by Schaefer (2019). The difficulty of improving spontaneously grown rules is noted e.g. in Hayek ([1964] 1967, p. 92).

¹³ On the function of the state, Mises says: “As the liberal sees it, the task of the state consists solely and exclusively in guaranteeing the protection of life, health, liberty, and private property against violent attacks. Everything that goes beyond this is an evil” (Mises, [1962] 2005, p. 30).

5. Hayekian Economic Policy: A Proposal

We have seen that, throughout his career, Hayek has given three different answers to the question of the appropriate role of the state in economic policy-making. First, he argues that the state should provide a framework for competitive markets. Second, he proposes to employ the rule of law criteria to distinguish permissible from non-permissible state interventions. Third, he rejects deliberate legislation, essentially moving closer to the Misesian idea of a minimal state.

At this point, it seems worthwhile to compare these answers to Hayek's larger body of work. Its overarching theme is usually considered to be the so-called knowledge problem (Rajagopalan and Rizzo, 2017; Vanberg, 2017). According to Viktor Vanberg, two aspects of the problem can be distinguished. Firstly, it refers to the limited knowledge and foresight of individuals. Secondly, it refers to the dispersed nature of knowledge in society (Vanberg, 2017, p. 32).

From a Hayekian perspective, individual knowledge is limited because people have limited information processing capabilities and live in a world of structural uncertainty.¹⁴ This applies to all individuals, including policy-makers (Scheall, 2020).¹⁵ Knowledge is dispersed because the best use of available resources is known only to the individual members of society.¹⁶ This suggests the need to coordinate individual actions, preferably via a decentralized and self-organizing process – i.e., the spontaneous order of competitive markets.

A Hayekian approach to economic policy needs to take into account both aspects of the knowledge problem. Such an approach should therefore meet two criteria. It needs to be modest in the sense

¹⁴ On Hayek's behavioral assumptions, which are reminiscent of Herbert Simon's concept of bounded rationality, see Dold and Lewis (2022).

¹⁵ For empirical evidence on the cognitive limitations and biases of policy-makers see Schnellenbach and Schubert (2015).

¹⁶ Specifically, the kind of knowledge that is dispersed in society is "the knowledge of the particular circumstances of time and place" (Hayek, 1945, p. 521), not scientific knowledge.

that it reduces the epistemological burden placed on policy-makers, and it needs to be conducive to the existence of a spontaneous order.

In terms of the knowledge requirements for policy-makers, it would be optimal to reduce the function of the state to enforcing spontaneously grown rules. It is, however, less clear that this arrangement would be conducive to the spontaneous order of the market. As John Gray has argued, we should be skeptical of Hayek's (1973) claim that market-supporting legal rules will appear spontaneously:

The truth is precisely the contrary: except in the context of a legal framework that guarantees voluntary exchange, there is no reason to suppose that spontaneous orders will be beneficent. ... Nor ... is there any reason to suppose that the unplanned evolution of legal systems will systematically favour market institutions as systems of voluntary exchanges. (Gray, 1994, p. 37)

Indeed, there is little empirical evidence to suggest that, left to their own devices, legal systems develop the way that Hayek envisions (Epstein, 2017, pp. 417–422). Thus, rather than waiting for the appropriate rules to emerge, Hayekian economic policy should aim to consciously create the conditions under which spontaneous ordering processes work best.¹⁷

When creating these conditions, how can we account for the limited knowledge and foresight of policy-makers? This brings us to Hayek's distinction between two ways in which the state may intervene in the economy: through setting up general rules of conduct or through specific instructions and prohibitions (Hayek, [1960] 2011, pp. 329–330).¹⁸

¹⁷ Even in his later works, Hayek acknowledges the possibility of this: “While the rules on which a spontaneous order rests, may also be of spontaneous origin, this need not always be the case. ... It is at least conceivable that the formation of a spontaneous order relies entirely on rules that were deliberately made” (Hayek, 1973, p. 45).

¹⁸ A special case which will not be discussed here are the interventions described today as “libertarian paternalism”, or nudging. On the importance of the Hayekian knowledge problem in this context see Sunstein (2021) as well as Rizzo and Whitman (2021).

Clearly, state intervention through specific instructions and prohibitions requires substantially more knowledge on the part of policy-makers than intervention through rule-making. In choosing the rule framework of the spontaneous market process, the policy-maker does not need to anticipate the results of individual measures. She merely needs to know which “rules of the game” are associated with overall beneficial outcomes. Hayek was optimistic about the possibility of obtaining this kind of knowledge:

Contrary to a widely held opinion, economic theory has much of importance to say about the effectiveness of different kinds of economic systems ... [and] it has comparatively little to say on the concrete effects of particular measures in given circumstances. We know the general character of the self-regulating forces of the economy and the general conditions in which these forces will function or not function, but we do not know all the particular circumstances to which they bring about an adaptation. (Hayek, [1963] 1967, p. 263)

We propose that a Hayekian approach to economic policy should aim to improve economic outcomes indirectly by improving the framework of general rules that guide individual behavior. Such an approach could be referred to as “government by rules”, an expression which Hayek himself occasionally uses (e.g., Hayek, [1946] 1948a, p. 19). The concept corresponds to that of *Ordnungspolitik*, a key idea of the German neoliberal movement (Eucken, 1952). Both concepts can be contrasted with discretionary interventions.

Hayekian economic policy would “intervene” in the economy by setting up general rules of conduct, thus accounting for the limited knowledge of policy-makers. The goal of these interventions would be to facilitate spontaneous ordering processes that take advantage of the dispersed knowledge of all members of society. The degree to which a policy serves to coordinate individual actions would be a major determinant of the “goodness” of this policy.¹⁹

Such an approach would be in line with Hayek’s ambition – from *The Road to Serfdom* – to construct a rational framework for economic activity. However, individual rules would need to comply with the rule of law criteria as put forward in *The Constitution of Liberty*. In addition,

¹⁹ On coordination as a criterion for the evaluation of economic policy see Kirzner (1998).

policy-makers would have to consider the utility or expediency of the rule in question. While their discretionary power would be restricted, policy-makers would have a much more active role in shaping competitive markets than suggested in *Law, Legislation and Liberty*.²⁰

Consider the example of environmental regulation to reduce Greenhouse gas (GHG) emissions.²¹ The regulation of this pollution externality is clearly within the purview of legitimate state action as described by Hayek (1979). Today's policy-makers have a number of different policy instruments at their disposal to help reduce GHG emissions (see Metcalf, 2019).

According to our proposal, a Hayekian approach to this issue would consider both aspects of the knowledge problem discussed above. Firstly, the approach would make use of the ordering principle of spontaneous order to account for the fact that knowledge is dispersed in society. Thus, it would favor market-based instruments over the direct regulation of GHG emissions or subsidies for “clean” technologies. Market-based instruments such as carbon taxes and cap-and-trade systems are designed to elicit changes in production and consumption by putting a price on emissions. Either the optimal amount of emissions (carbon tax) or the optimal price of emissions (cap-and-trade) will be determined by the market. This type of regulation also provides clear incentives for the emergence of low-carbon innovation.

Secondly, a Hayekian approach would have to be sufficiently general to account for the limited knowledge of policy-makers. In the context of our example, generality means that different sources of emissions must be subject to the same price. An economy-wide price for emissions is important to avoid difficult-to-anticipate leakage effects and to encourage innovation in all polluting sectors. The Hayekian recommendation deviates from existing carbon taxes and cap-and-trade systems, which target specific industries. While there are political reasons for this kind of implementation, the Hayekian approach suggests that environmental regulation should conform to the rule of law.

²⁰ For a similar proposal, incorporating additional insights from Austrian economics, see the “market-process policy programme” put forward by Harper (2003).

²¹ This example was inspired by the discussion of environmental regulation in Buchanan and Congleton (1998, pp. 64–65).

6. Conclusion

What is the appropriate role of the state in economic policy-making? Our paper shows that Hayek, rather than simply being a proponent of *laissez-faire*, gives three different answers to this problem. First, he argues that the state should provide a legal framework for competitive markets. Second, in response to criticism by Keynes, he proposes to employ the rule of law criteria – generality, equality, and certainty – to distinguish permissible from non-permissible state interventions. Third, he rejects deliberate legislation and moves much closer to the Misesian idea of a minimal state.

The paper considers these answers in light of Hayek’s broader oeuvre, in particular the overarching theme of knowledge. Based on his analysis of the knowledge problem, we contend that a Hayekian approach to economic policy should have two objectives: To reduce the epistemological burden placed on policy-makers and to make use of spontaneous ordering processes.

Consequently, we propose that “Hayekian economic policy” should focus on improving the framework of general rules that guide individual behavior, rather than bringing about certain results by direct intervention. Using the example of environmental regulation to constrain GHG emissions, we demonstrate how the two objectives of Hayekian economic policy can be utilized to assess and inform real-world policy.

While this paper highlights what might be considered inconsistencies in Hayek’s views on economic policy, our principal message is that his work contains important arguments in favor of a particular approach to policy-making – government by rules – that takes into account both the limited knowledge of policy-makers and the fact that knowledge is dispersed among the members of society.

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