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Knowledge's Limits and a Nobel Economist's Humility

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Friedrich Hayek stressed the limits of our knowledge and the need for humility to understand the economy.

HALF A CENTURY AGO, A LARGELY FORGOTTEN ECONOMIST received the unexpected news that he had been awarded the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel. Friedrich A. Hayek was equally surprised to find himself sharing the sixth Nobel Prize in Economics with Gunnar Myrdal. The Swedish economist's decidedly social democratic views could not have been more removed from Hayek's classical liberal outlook.

There was, however, one commonality between these two unlikely prize co-recipients. As the Royal Swedish Academy of Sciences noted in its press release announcing the 1974 Nobel economics laureates, one reason for both men receiving the Prize was "their penetrating analysis of the interdependence of economic, social, and institutional phenomena." Myrdal, for example, had written on race relations in America from an interdisciplinary standpoint. His work in this area was cited in the US Supreme Court's *Brown v. Board of Education* judgment.

As Bruce Caldwell and Hansjoerg Klausinger illustrate in *Hayek: A Life, 1899–1950*, Hayek had taken his own extra-economic turn in the late 1930s as the Austrian economist sought to understand why the world was seeking salvation through greater state control over the economy and society more generally. This process accelerated when Hayek joined the University of Chicago's Committee on Social Thought in 1950.

A common theme marking Hayek's exploration of subjects like psychology, political science, and law was the conviction that the social sciences, including economics, had taken a wrong turn when they sought to follow as closely as possible the methods employed in the natural sciences. What Hayek called "scientism" had subsequently distorted economics by narrowly focusing it on what is measurable and observable. While that might work in the physical sciences, Hayek held that excessive reliance upon this methodology was bound to produce misleading conclusions when applied to the type of human interactions and knowledge that is the subject matter of economics. It was a theme to which Hayek would continually return, not least because it went to the heart of the nature of economics and its potential to contribute to human well-being.

"Old" versus "New" Economics

Hayek was not the only economist to lament postwar economics' scientistic turn following efforts by Keynes's disciples to concentrate the discipline upon quantifiable macro-aggregates that, many postwar economists believed, could provide them with the information that governments and technocrats needed to direct and manage the economy.

Hayek's fellow market liberal Wilhelm Röpke wrote at length on the same topic. In a 1952 essay, "Keynes and the Revolution in Economics," Röpke observed that the "new economics" embodied an entirely different logic to that of (pre-Keynesian) "old economics." It was, however, Hayek who most systematically explored the philosophical origins of this shift and its political and economic consequences.

The most famous of Hayek's ventures into this area was his 1945 *American Economic Review* article "The Use of Knowledge in Society." Its immediate target was the thesis of left-leaning economists like the Polish socialist Oskar Lange that economic planning was compatible with the price mechanism's workings. To this extent, Hayek's article formed part of the socialist calculation debate that had been litigated since the 1920s. What made Hayek's 1945 article distinct was that it addressed some of the underlying epistemological questions driving this debate: most notably, the perennial question of what human reason can really know. In Hayek's view, this was the decisive point that made economic planning a generally ineffectual and potentially dangerous exercise.

"Today," Hayek stated in 1945, "it is almost heresy to suggest that scientific knowledge is not the sum of all knowledge." Yet, he stressed, there are other types of information, much of which is specific to individuals. These include "knowledge of the particular circumstances of time and place." Possession of such tacit and thus largely unmeasurable information gives, Hayek observed, "practically every individual … some advantage over all others in that he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or made with his active cooperation."

This state of affairs also creates significant challenges for government economic planning, insofar as it simply cannot keep up with the ongoing incremental changes in, and exchanges of, information to which individuals are constantly reacting at the micro-level of what Hayek calls "the economy of knowledge." No planner can know the sheer number of changing factors (not least among which are the ever-changing preferences of billions of individuals as they react to unending price changes) that affect the prices of millions of goods and services at any one

moment in time. The post-Keynesian emphasis on collating and acting upon macro-aggregates of the limited forms of information that did lend themselves to measurement positively discourages governments and technocrats from even thinking about these unknowables in the first place. This is bound to lead to significant policy errors, not least because it involves, as Hayek wrote, a willingness "to assume the problem away and to disregard everything that is important and significant in the real world."

A Type of Vindication

In the three decades following the publication of Hayek's 1945 essay, Western economies generally enjoyed steady economic growth, low unemployment, and low inflation. Contra Hayek, it seemed that governments aided by those trained in the new economics could successfully direct economic life towards the realization of very precise predetermined ends. "Old economics," as personified by Hayek and a few market liberals, appeared dead.

Confidence in these propositions began weakening in the late-1960s as Western economy after Western economy started experiencing what practitioners of the "new economics" had regarded as an improbable scenario: high unemployment accompanied by growing inflation. These circumstances and the awarding of the Nobel Prize to Hayek in 1974 provided renewed attention to the now-elderly economist's critique of planning and the alternative economic ideas with which he was associated.

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No one would have been surprised if Hayek had chosen to use his Nobel lecture to dwell on the immediate economic problems of the 1970s or engage in an "I-told-you-so" retrospective. Hayek, however, decided to expand upon the epistemological questions addressed in his 1945 article and other papers—most notably, his three-part "Scientism and the Study of Society" essay, published in *Economica* in 1942, 1943, and 1944. This is what makes Hayek's Nobel Prize lecture, "The Pretense of Knowledge," one of his most important intellectual contributions and why it repays careful reading 50 years after Hayek delivered it in Stockholm.

Hubris is Costly

Hayek started his Nobel lecture with the somewhat polemical observation that economists were being called upon to save the free world from "accelerating inflation" which, Hayek insisted, had resulted from policies that "the majority of economists recommended and even urged governments to pursue." To Hayek's mind, this was symptomatic of the extent to which the economics profession had "made a mess of things."

Central to this crisis of economics, Hayek contended, was "the 'scientistic' attitude" that underlay postwar economics. For three decades, he maintained, economists had insisted that there was "a simple positive correlation between total employment and the size of the aggregate demand for goods and services." This, Hayek added, led "to the belief that we can permanently assure full employment by maintaining total money expenditure at an appropriate level."

For Hayek, however, what mattered was that underneath this conviction was a heavy reliance upon totalities of "quantitative data." But the capacity of such data, according to Hayek, to capture phenomena as complicated as inflation and unemployment was "necessarily limited." There are, Hayek recognized,

> a great many facts which we cannot measure and on which indeed we have only some very imprecise and general information. And because the effects of these facts in any particular instance cannot be confirmed by quantitative evidence, they are simply disregarded by those sworn to admit only what they regard as scientific evidence: they thereupon happily proceed on the fiction that the factors which they can measure are the only ones that are relevant.

Put another way: just because you can't measure something doesn't mean that it doesn't exist or isn't important. It follows, Hayek argued, that calculating grand aggregates of that limited number of things that lend themselves to measurement, and then trying to develop theories to explain the relationships between such aggregates, was bound to produce explanations for, say, rising inflation that were insufficiently attentive to what was happening at the micro-level of the economy.

Hayek illustrates the point by examining the phenomenon of how prices and wages are formed in a market economy. "Into the determination of these prices and wages," Hayek explained, "there will enter the effects of particular information possessed by every one of the participants in the market process—a sum of facts which in their totality cannot be known to the scientific observer, or to any other single brain." Economists cannot consequently know, no matter how sophisticated the econometric model, "which particular structure of prices and wages demand would everywhere equal supply."

This does not mean that Hayek thought that using mathematics in economics was a waste of time. Such techniques, he observed, can help trace general patterns. They cannot, however, encapsulate everything that determines the formation of prices because no model can capture all the information that goes into shaping prices.

This, Hayek pointed out, had been well understood by sixteenth-century natural law philosophers like the Jesuits Luis Molina and Juan de Lugo who studied at the University of Salamanca. They emphasized, Hayek commented, "that what they called *pretium mathematicum*, the mathematical price, depended on so many particular circumstances that it could never be known to man but was known only to God."

No Humility, No Freedom

Therein lay the normative and political significance of Hayek's Nobel lecture. At its core was a plea for economists to avoid the hubris encouraged by scientism. This was not only about maintaining the discipline's integrity as a social science. It was also a matter of being realistic about economics' predicative powers: a realism which should discourage unrealistic expectations on the part of governments and citizens about what economics, economic policy, and economists can do.

Calibrating such expectations correctly was, for Hayek, crucial for two reasons. First, Hayek insisted, "The conflict between what in its present mood the public expects science to achieve in satisfaction of popular hopes and what is really in its power is a serious matter." Overblown hopes lead to voters imagining that governments can deliver economic outcomes simply by pulling various interventionist levers, and political leaders and technocrats behaving as if they can do so. That is a recipe for disappointment and, potentially, deep disturbances in the body politic.

The second reason for Hayek's concern was, in a word, civilizational. When economics and economic policy are infected by the scientism virus, we start to imagine that we can improve the social order at will via top-down control. Such a "fatal striving," as Hayek described it, fueled by the refusal to recognize "the insuperable limits to his knowledge," can make someone "not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals."

From this standpoint, the significance of Hayek's Nobel lecture went beyond economics. Rather it was a generic appeal for something that seems perpetually in abeyance: intellectual and political humility. For Hayek, successfully improving society via economics or any other social science was premised upon accepting that there are areas of human life of which, he told his audience of Swedes in 1974, we "cannot acquire the full knowledge which would make mastery of the events possible."

At the time Hayek spoke these words, doubts about the capacity of government planning to master economic affairs were coming back into fashion. Within six years of his lecture, Ronald Reagan and Margaret Thatcher were in office and promising a decisive break with postwar interventionist policies.

That world seems very distant from today. Much of the right has joined the left in insisting that government can and must be used to deliver very specific economic outcomes, through means like activist central banks, protectionism, industrial policy, and greater regulation. Even price controls are being entertained across the political spectrum.

The difficulty with so many of these policies is that they deny Hayek's observation that we are not gods or God and that therefore neither economists nor government officials possess the divine-like qualities that they would need to overcome the serious limitations created by the knowledge problem. Such were Hayek's convictions on this matter that he expressed doubts during his Nobel banquet dinner remarks about the prudence of creating a Nobel economics prize in the first place. Among other things, Hayek feared that it would confer "an individual an authority which in economics no man ought to possess."

Humility is not usually found among those trying to build heaven-on-earth or who want to save the world through technocracy. It is, however, something that keeps us in touch with reality about the economy, society, and ourselves. That is what makes Hayek's Nobel message about our capacity for knowledge such a powerful exercise in truth-telling for the ages.

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