601 PENNSYLVANIA AVE, NW
NORTH BUILDING, SUITE 700
WASHINGTON, DC 20004

FreedomWorks

CAPITOLCOMMENT

www.freedomworks.org

Number 429 February 2, 2009

The Stimulus v. The Knowledge Problem

Revisiting the Hayek-Keynes Debate as Keynesianism Returns to Washington

by Joseph Onorati

We are being told by members of Congress, the president, and the media that a government deficit spending program can stimulate economic growth. The theories of John Maynard Keynes, espoused in his book, *The General Theory of Employment, Interest, and Money*, are the original foundation of the idea. Nobel Prize winning Austrian economist Friedrich A. Hayek famously debated Keynes in economic publications over several decades about sixty years ago on that topic. The Keynesian stimulus proposal will fail for the same reasons today that Hayek told Keynes his new idea would fail last century.

Keynes argued that individual elements in an economy can be aggregated into meaningful numbers and that data can be analyzed to make conclusions about the health or state of an economy. One of Keynes' primary economic indicators was aggregate demand that he calculated by adding up all the purchases of final goods in a country in a given time period at a certain price level. Keynes believed that maintaining a steady growth rate of aggregate demand should be the goal of fiscal policy.

Hayek's primary critique of Keynes was that his view of the economy is too simple. Keynes reduced millions of individuals interacting in the economy to a single number. Hayek argues that economists just do not know enough about economics or the inter-relatedness of human interaction to have a calculation like that make any sense, much less to base policy decisions on it.

Much of what we can really know, Hayek emphasizes, is that individuals choose. We cannot know if the choices they make are the best for them, but we also cannot know if choices that someone else makes for them are better. He advocated individualism because the individual making the decisions often directly feels the consequences of his own behavior. He explains, "The real question, therefore, is not whether man is, or ought to be, guided by selfish motives but whether we can allow him to be guided in his actions by those immediate consequences which we can know and care for or whether he ought to be made to do what seems appropriate to somebody else who is supposed to possess a fuller comprehension of the significance of these actions to society as a whole."[1]

Markets are a process by which individuals interacting with one another tend toward better and better outcomes over time. When individuals are allowed to try things they learn through trial and error about what methods are

---

Joseph Onorati (jonorati@freedomworks.org) is Staff Writer at FreedomWorks.

effective or profitable. They receive signals via markets in the form of profit and loss. Those feedback mechanisms provide information for individuals as they discover new ways of satisfying consumers and tend toward better outcomes over time.[2]

Keynes' theory lacks microeconomic foundations that are present in most other economic theories about human action, including Austrian market process theory. Individuals are absent in his model. Hayek's work on knowledge stands against Keynes' theory with the argument that we simply cannot know whether an economy is made better off by leveling out aggregate demand. It is certainly true that if the government is borrowing and spending the money, the signaling mechanisms that would let individual market actors know whether their decisions are sound or not are to some extent destroyed. Hayek would emphatically say that we simply cannot know whether or not outcomes derived from government manipulation of aggregate demand make individuals or an economy better off. We do, however, know that individuals interacting peacefully and freely with one another do, through trial and error, produce better and better outcomes over time.

When power is taken out of the hands of many and given to a few, those few often do not encounter the same feedback mechanisms that an individual would have if they were making their own decisions. The process by which markets move is the best process that we have for determining whether outcomes are positive or not. The lack of feedback in centrally planned decisions prevents the trial and error process of discovery that allows markets to work. Essentially, when we hand over power to the state, some of the feedback mechanisms provided through profit, loss, and various other institutions are lost.

Hayek's most famous book, *The Road of Serfdom* puts together another serious critique of Keynesianism. Hayek writes that government acting with coercive force with a society-wide goal is collectivist.[3] Because knowledge and the feedback through profit and loss to individual entrepreneurs are localized, individualism will tend toward better outcomes for societies than collectivism.[4] Keynes, however, in his arguments concerning aggregate demand, ignores the individual. His arguments are, at their base, collectivist ones. He has a goal for society that he encourages governments to enact: The steady increase of aggregate demand.

Concerning how we can go about fighting Keynesian theory and the policies that follow from it, Hayek writes, "Whatever may be our hope for the future, the one thing of which we must be painfully aware at the present time... is how little we really know of the forces that we are trying to influence by deliberate management; so little indeed that it must remain an open question whether we would try if we knew more."[5] The economy is much more complicated than Keynes, President Obama, his team of economic advisors, and much of Congress make it out to be. Even the best trained economists cannot possibly know the effects of more government spending. We should stick to what we do know works – individuals peacefully and freely interacting with each other in an unhampered market economy.

---

1. Hayek, F.A., "Individualism: True and False," *Individualism and Economic Order.* (The University of Chicago Press. 1948.) Pg. 14.

2. Kirzner, Isreal., *Competition and Entrepreneurship*. (University of Chicago Press. 1978.)

3. Hayek, "Individualism: True and False"

4. Hayek, F.A., "The Use of Knowledge in Society." *Individualism and Economic Order*. (The University of Chicago Press. 1948.)

5. Hayek, F.A., *Monetary Theory and the Trade Cycle*. (Augustus M. Kelley Publications. 1933.)