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Hayek, Buchanan and the justification of the market

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Abstract

This paper discusses the work of two twentieth-century liberal economists, Friedrich Hayek and James Buchanan, who have made lasting contributions to our understanding of the role of the market in a free society. I argue that they offer significantly different but complementary visions of the value of the market as a system of individual freedom. Hayek's vision is of the price system as a marvel of spontaneous order which solves a fundamental economic problem – that of making efficient use of a totality of knowledge that is divided between individuals. Buchanan's vision is of the market as a space in which individuals are free to make voluntary exchanges. In his words, 'this is all that there is to it': the market is not a solution to any collective problem. These visions have a common blind spot. Both writers recognise the need for programmes of social insurance and consider how they should structured so as to be as compatible as possible with the workings of a market economy and a liberal democracy. But, I argue, neither sees the full importance of social insurance in a justification of the market system.

JEL CLASSIFICATION
B31 (history of economic thought: individuals), B41 (economic methodology)

1 | INTRODUCTION

By any reckoning, Friedrich Hayek and James Buchanan are two of the greatest liberal economists of the twentieth century.[1] Each has made lasting contributions to our understanding of the role of the market in a free society. In this paper, I compare their understanding of the market and their ways of justifying it. I argue that Hayek and Buchanan offer significantly different but complementary visions of the market as a system of individual freedom. However, as I shall also argue, these visions have a common blind spot in relation to social insurance. Of course, like all serious economists, Hayek and Buchanan recognise the need for public programmes of income support. They both consider how such programmes might be structured so as to interfere as little as possible with the workings of a market economy and a liberal democracy. But, I will maintain, they do not see the full importance of social insurance in a justification of the market system.

2 | HAYEK'S VISION OF THE MARKET

Hayek's (1945) paper 'The Use of Knowledge in Society' (*UoK*) is, for me at least, one of the most significant economic theory papers of the last century. It begins with a rhetorical question: 'What is the problem we wish to solve when we try to construct a rational economic order?' Implicit in this question is a premise that Hayek clearly accepts – that designing a rational economic order (or, in another of Hayek's expressions, an 'efficient economic system') is at least *a* – at one point he suggests *the* – fundamental 'economic problem of society'. The target of Hayek's critique is a particular construal of that problem that he attributes to many economic theorists of the time. In that construal, the problem is one of logic – the 'Pure Logic of Choice'. But that, Hayek says, 'is emphatically not the economic problem that society faces' (*UoK*: 518–521). The essential feature of the real problem is that its solution requires the integration of knowledge that is in fact dispersed among many individuals. It is:

> a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.
>
> (*UoK*: 520)

This is the problem of the *division of knowledge*.

One of Hayek's most important insights is that economic theorists neglect – indeed denigrate – the 'unorganized knowledge' that every economic agent has about 'particular circumstances of time and place'. Because the things that are known are so disparate and fleeting, they are not easily systematised in theoretical models. Nor are they easily communicated to or assimilated by economic planners. Nevertheless, many of the general properties of economic life that feature in economists' theories can occur only because individual agents are constantly adjusting their behaviour in the light of unorganised knowledge. Thus, for example, the tendency of firms to produce at minimum cost depends on 'constant struggle' by managers to keep costs from rising; the ability of a firm to secure a constant supply of inputs over time depends on 'B stepping in at once when A fails to deliver'; the tendency for given commodities to trade at single prices depends on the alertness of arbitrageurs who buy cheap and sell dear (*UoK*: 521–524). Clearly, such adjustment mechanisms depend on the existence of economic agents who seek material gain, and on rules that allow free entry to markets: the manager struggles to keep costs from rising because of the danger of their firm's prices being undercut by other firms; B is able to step in because free entry is permitted, and chooses to do so because this is profitable; the arbitrageur spots an opportunity for profit by buying in one market and selling in

[1]This article appears in *Kyklos* as part of a trilogy of papers (by Kliemt, 2024, Sugden 2024 and Vanberg, 2024) presented at a symposium at the Justus-Liebig-University Giessen in 2022 in commemoration of the 40th anniversary of awarding honorary doctoral degrees to F.A. v. Hayek and J.M. Buchanan for their seminal work on the political economy and philosophy of Constitutional Democracy.

another. In *UoK*, Hayek takes profit-seeking and free entry as given properties of competitive markets and focuses on the information requirements of these adjustment mechanisms. How do economic agents know what adjustments are needed?

Hayek's answer is that this problem ‘can be solved, and is in fact being solved, by the price system’. The price system is the coordinating mechanism that allows competitive markets to allocate resources efficiently:

> [I]n a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to co-ordinate the separate actions of different people in the same way as subjective values help the individual to co-ordinate parts of his plan.
>
> (*UoK*: 526)

Hayek asks us to suppose that, somewhere in the world, a new opportunity arises for the use of tin. Efficiency requires that existing users of tin economise on their use of the metal, which implies further requirements about the use of substitutes for tin, and so on. All the required effects occur in response to an increase in the price of tin which (because of arbitrage, and after allowing for transport costs) is the same everywhere in the world.

Hayek asks us to see this as a marvel of spontaneous order:

> The marvel is that in a case like that of a scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly.
>
> (*UoK*: 527)

In a striking metaphor, expressed in terms of what at the time was modern technology, Hayek describes the price system as

> a system of telecommunications which enables individual producers to watch merely the movement of a few pointers, as an engineer might watch the hands of a few dials, in order to adjust their activities to changes of which they may never know more than is reflected in the price movement.
>
> (*UoK*: 527).

This account of the marvel is a preface to some extraordinarily grand claims about the significance of the price system in human history:

> I am convinced that if it were the result of deliberate human design, and if the people guided by the price system understood that their decisions have significance far beyond their immediate aim, this mechanism would have been acclaimed as one of the greatest triumphs of the human mind.
>
> (*UoK*: 527).

> The price system is just one of those formations which man has learned to use (though he is still very far from having learned how to make best use of it) after he had stumbled upon it without understanding it. Through it not only a division of labour but also a co-ordinated utilization of resources based on an equally divided knowledge became possible. … [M]an has been able to develop that division of labour on which our civilization is based because he happened to stumble upon a method which made it possible.
>
> (*UoK*: 528)

Consider what these passages reveal about Hayek's vision of the market. The fundamental mechanism of the market is the price system. The price system is the best solution we have to the problem of constructing a rational economic order. Although this system was not a product of human design, we can understand it as a rational solution to a problem faced by all human societies – the problem of coordinating economic activity in the face of dispersed knowledge. The metaphor of the engineer and the dials is, I think, particularly revealing. In Hayek's picture of the market, the price system substitutes for economic relationships between individuals. Each person pursues their own ends and acts on their own knowledge while keeping a close watch on the economic pointers which keep them informed about prices. The marvel is that the impersonality and parsimony of the price system is sufficient to ensure that a whole economy, however large, uses resources efficiently. Significantly, Hayek's examples of the use of unorganised knowledge are typically the actions of individuals who respond to impersonal price signals in the light of their private knowledge. Thus, for example, the manager in Hayek's example struggles to keep down the cost of manufacturing some given product. Contrast the kind of entrepreneurship described by William Stanley Jevons, (1871/1970): (102–103) in a founding text of neoclassical economics: 'Every manufacturer knows and feels how closely he must anticipate the tastes and needs of his customers: his whole success depends on it'. Jevons's manufacturer is *sensing* demands that have yet to reveal themselves in prices.[2]

Writing three decades later in Volume 2 of *Law, Legislation and Liberty* (*LLL2*: Hayek, 1976), Hayek is more explicit about what makes the 'market order' desirable. Rejecting the idea that a rational economic policy must be based on 'a common scale of concrete ends', he presents his own view of what rationality requires:

> Policy need not be guided by the striving for the achievement of particular results, but may be directed towards securing an abstract overall order of such character that it will secure for the members the best chance of achieving their different and largely unknown particular ends. The aim of policy in such a society would have to be to increase equally the chances for any unknown member of society of pursuing with success his equally unknown purposes.
>
> (*LLL2*: 114)

Hayek argues that this aim can be best achieved by using the spontaneous ordering forces of the market but with a safety net of support for those who would otherwise fall into absolute poverty. The principal recommendation of the market is that it is a 'wealth-producing game' (*LLL2*: 115). Its motive power is each person's pursuit of their own ends in a system in which each is rewarded for satisfying the unknown wants of other people. Thus:

> When we reflect that most of the benefits we currently owe to the market are the results of continuous adaptations which are unknown to us, and because of which only some but not all of the consequences of our deliberate decisions can be foreseen, it should be obvious that we will achieve the best results if we abide by a rule which, if consistently applied, is likely to increase everyone's chances. Though the share of each will be unpredictable, because it will depend only in part on his skill and opportunities to learn facts, and in part on accident, this is the condition which alone will make it the interest of all so to conduct themselves as to make as large as possible the aggregate product of which they will get an unpredictable share.
>
> (*LLL2*: 122).

[2]I do not want to say that Hayek never considers this aspect of markets. In Hayek (1948), for example, he discusses imperfect competition, particularly in markets for services. He points out the unrealism of the 'explicit and complete exclusion from the theory of perfect competition of all personal relationships existing between the parties' and says that one of the functions of competition is 'to teach us *who* will serve us well: which grocer or travel agency, which department store or hotel, which doctor or solicitor, we can expect to provide the most satisfactory solution for whatever particular personal problem we may have to face' (1948: 96–97). But the impersonal price system is at the core of Hayek's account of the market.

Appealing to the economic history of the preceding 200 years, Hayek argues that economic growth tends not only to increase absolute incomes but also to increase the relative wages of the lowest-paid (*LLL2*: 131). In addition, the increase in aggregate income created by the market has 'made it possible to provide outside the market for the support of those unable to earn enough' (*LLL2*: 139).

Hayek has a further reason for seeing the market order as morally valuable – its contribution to liberty. In *The Constitution of Liberty* (*CoL*: Hayek, 1960), Hayek discusses alternative conceptions of freedom. He favours a *negative* conception, according to which a person is free to the extent that they are 'not subject to coercion by the arbitrary will of another or others' (*CoL*: 11). Coercion is 'such control of the environment or circumstances of a person by another that, in order to avoid greater evil, he is forced to act not according to a coherent plan of his own but to serve the ends of another'. It is 'evil precisely because it thus eliminates an individual as a thinking and valuing person and makes him a bare tool in the achievement of the ends of another' (*CoL*: 20–21). Because of the impersonality of the price system, the constraints that individuals face in a competitive market are not coercive (*CoL*: 119–122, 135–137). However, although Hayek clearly believes that freedom has intrinsic value,[3] he suggests that the most important benefit that most people derive from living in a free society derives from the wealth-creating effects of *other people's* freedom *CoL*: 18, 29).

It is fundamental to Hayek's understanding of the market that the benefits that individuals derive from it cannot be interpreted as rewards for merit. In the market system, individuals are rewarded according to the benefit their activities confer on others, as valued by those others. Necessarily, therefore, each person's income depends on the match between (on the one hand) their own native and learned abilities and (on the other) other people's preferences and the state of technology. Because of the division of knowledge, each individual's expectations are constantly liable to be disappointed without that individual being at fault. Conversely, individuals are liable to receive benefits that they have done nothing to deserve (*CoL*: 93–99). These are unavoidable properties of a system in which information is transmitted by prices. For example, take Hayek's case of the increase in the price of tin. At one and the same time, this price increase is a piece of information about a change in world demand for tin and a source of loss to producers and consumers of tin-based products. Those producers and consumers cannot be held to be at fault for not acting on that information before it was transmitted to them.

Hayek's moral response to this fact of economic life connects with his negative conception of freedom. Considering the results of the workings of the market, he asks:

> Are we not all constantly disquieted by watching how unjustly life treats different people and by seeing the deserving suffer and the undeserving prosper? And do we not all have a sense of fitness, and watch it with satisfaction, when we recognize a reward to be appropriate to effort or sacrifice?
>
> (*CoL*: 68)

Of course, the answer is that we do. But, Hayek says:

> [W]e experience the same feelings also with respect to differences in human fates for which clearly no human agency is responsible and which it would therefore clearly be absurd to call injustice … It is certainly tragic to see the failure of the most meritorious efforts of parents to bring up their children, of young men to build a career, or of an explorer or scientist pursuing a brilliant idea. And we will protest against such a fate although we do not know anyone who is to blame for it, or any way in which such disappointments can be prevented.
>
> (*CoL*: 69)

[3]For example, Hayek says: 'The general in charge of an army or the director of a large construction project may wield enormous powers which in some respects may be quite uncontrollable, and yet may well be less free, more liable to have to change all his intentions and plans at a word from a superior, less able to change his own life or to decide what to him is most important, than the poorest farmer or shepherd' (*CoL*: 17). I take Hayek to be saying that there is something good in the lives of the farmer and the shepherd that is missing from the lives of the general and the director.

Hayek is asking us to think of the outcomes of the market as if they were the result of natural forces. These outcomes may be disappointing or even tragic, but they do not impinge on anyone's freedom. In this sense, they are not unjust.

3 | BUCHANAN'S VISION OF THE MARKET

In his paper 'What Should Economists Do?' (*WSED*; Buchanan, 1964), Buchanan challenges Lionel Robbins's (1935: 16) famous definition of economics as 'the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses'. As the title of his paper makes clear, Buchanan's concern is not with what economists in fact do, but with what they *should* do. He recognises that Robbins's definition fits the practices of many of his fellow economists, but tries to persuade his readers that economics has taken a wrong turn.

In several respects, Buchanan's critique of what economists were doing in the 1960s echoes Hayek's comments on how the economists of the 1940s treated the Pure Logic of Choice as a method of solving the economic problem of society. Like Hayek, Buchanan rejects the idea that social choice should be construed as the maximisation of a single objective function (*WSED*: 215–217).[4] Also like Hayek, Buchanan argues that competitive equilibrium must be understood as a tendency in a system in which individual agents pursue their own ends, and not merely as a solution to a set of simultaneous equations (*WSED*: 218–219). But there are significant differences between Hayek's and Buchanan's conceptions of economics.

Buchanan's most fundamental objection to Robbins's definition is that Robbins treats 'our subject field [as] a problem or set of problems, not a characteristic form of human activity' (*WSED*: 214). For Buchanan, the subject matter of economics is the human activity of *exchange*. On the first page of his paper, he quotes a famous remark by Adam Smith:

> This division of labour, from which so many advantages are derived, is not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion. It is the necessary, though very slow and gradual consequence of a certain propensity in human nature which has in view no such extensive utility; the propensity to truck, barter, and exchange one thing for another.
>
> (Smith, 1776/1976: 25)

Buchanan argues that the 'relevance and significance' of this remark has been overlooked by economists. It is Smith's 'answer to what economics or political economy is all about' – or, in other words, Smith's answer to the question of what economists should do. Buchanan reads Smith in support of the view that the core theory of economics should be the theory of markets, not the theory of resource allocation, and that economists should concentrate on exchange rather than on choice (*WSED*: 213–216).

Buchanan suggests that economics as it should be would better be named 'symbiotics':

> Symbiotics is defined as the study of the association between dissimilar organisms, and the connotation of the term is that the association is mutually beneficial to all parties. This conveys, more or less precisely, the idea that should be central to our discipline. It draws attention to a unique sort of relationship, that which involves the cooperative association of individuals, one with another, even when individual interests are different.
>
> (*WSED*: 217)

[4]See also Buchanan's (1954a) critical discussion of Arrow's impossibility theorem.

Buchanan uses the story of Crusoe and Friday to illustrate this conception of a unique sort of relationship. Before the arrival of Friday, Crusoe faces problems of resource allocation that are susceptible to analysis by a pure theory of choice. Symbiotics becomes relevant only when Friday arrives, and when Crusoe (and Friday, though Buchanan omits to say this) recognise that their interests diverge but that 'mutual gains can be secured through cooperative endeavor'. Buchanan concludes: 'This mutuality of advantage that may be secured by different organisms as a result of cooperative arrangements, be these simple or complex, is the one important truth in our discipline' (*WSED*: 217–218).

Continuing the theme of resource allocation versus exchange, Robbins-style economics versus symbiotics, Buchanan asks 'How should the economist conceive the market organization?', and offers two contrasting answers. One answer would appeal to those economists who focus on the 'wealth of nations' or on the 'logic of choice':

> [T]he economist will look on market order as a means of accomplishing the basic economic functions that must be carried out in any society. The 'market' becomes an engineered construction, a 'mechanism', an 'analogue calculating machine', a 'computational device', one that processes information, accepts inputs, and transforms these into outputs which it then distributes.
>
> (*WSED*: 219)

Buchanan's answer is radically different:

> The 'market' or market organization is not a means toward the accomplishment of anything. It is, instead, the institutional embodiment of the voluntary exchange processes that are entered into by individuals in their several capacities. This is all that there is to it.
>
> (*WSED*: 219)

Buchanan's view of what economists should do is surely intended to be broader than the scope of his own work. It is therefore useful to look at how Buchanan summarises his own work in two retrospective accounts published in 1986. In one of these, he writes:

> My interests in understanding how the economic interaction process works has always been instrumental to the more inclusive purpose of understanding how we can learn to live one with another without engaging in Hobbesian war and without subjecting ourselves to the dictates of the state. The 'wealth of nations,' as such, has never commanded my attention, save as a valued by-product of an effectively free society. The ways and means through which the social order might be made more 'efficient' in the standard meaning – these orthodox guidelines have carried relatively little weight for me.
>
> (1986a: 74)

In the other, he expresses his personal commitment to the value of freedom, tracing this back to the 'libertarian socialist' views he held before going to the University of Chicago in 1945. Although he soon gave up the socialism, he retained the libertarianism, which he characterises as follows:

> The person who shares this perspective places a primary value on *liberty*, as such. He personally disputes, rejects, resents, opposes attempts by others to exercise control or power over his own choice behaviour. He does not like harness. There is an exhilaration in simply being free.
>
> (1986b: 4)

This attitude to liberty, he says, is encapsulated in the words 'Don't tread on me' on the rattlesnake flag flown in the American War of Independence (Buchanan, 1986b: 5).

4 | COMPARING THE TWO VISIONS

It should be obvious by now that Hayek's work does not fit easily into Buchanan's binary classification scheme.

Clearly, Hayek is presenting a theory of markets rather than a theory of choice. But it is equally clear that this theory is presented as a solution to a problem of economic organisation – the problem of constructing a rational economic order. The market order is rational because it achieves a coordinated utilisation of resources and makes as large as possible the aggregate product of which each member of society will get an unpredictable share. To use Buchanan's expressions, Hayek is concerned with the wealth of nations; he is looking at the market order as a means of accomplishing the basic economic functions that must be carried out in any society. Although Hayek does not think of this order as a product of deliberate human design, his theory is an exercise in reverse engineering. The market order, as described by Hayek, is unquestionably a mechanism that processes information.

As I noted in Section 2, Hayek theorises the market as an impersonal mechanism in which coordination is achieved by the price system. There is nothing in that theory that corresponds with Crusoe's and Friday's mutual recognition of common interests that can be secured by cooperation. To some extent, it must be said, that this is merely a difference between the levels at which Hayek and Buchanan are modelling. Hayek sets out to model a large economy in which many transactions, even between immediate buyers and sellers, are impersonal. Perhaps more importantly (and as Smith [1776/1976: 22–23] illustrated with the example of the day labourer's woollen coat), one of the marvels of the market is that it intermediates transactions between individuals who are completely unknown to one another. In contrast, Buchanan is deliberately using the simplest possible models as a means of isolating what he sees as fundamental social mechanisms. Nevertheless, Buchanan's vision of the market foregrounds mutual advantage in a way that Hayek's does not. Buchanan is inviting us to see that a large and apparently impersonal competitive economy can be factored down to mutually advantageous exchanges.[5]

There is a striking contrast between the awe with which Hayek views the spontaneous order of the market and Buchanan's 'This is all that there is to it'. In part, this contrast is a matter of context. Buchanan is challenging the idea that normative economics should be about maximising an objective function which in some sense belongs to society. He is saying (as Hayek does too) that there is no such single objective; there are many different individuals, each with their own interests and purposes. Buchanan may not be disagreeing with Hayek's claim that the market tends to increase the aggregate wealth of society. (We have been told that this is not a matter that has commanded Buchanan's attention.) But my sense is that Buchanan would not have shared Hayek's sense of wonder about humankind's stumbling on the marvel of the market. Buchanan has endorsed Smith's hypothesis that the propensity to truck, barter and exchange is a fundamental property of human psychology, and has recommended economists to treat this an axiom of their science. If that hypothesis is true, there must be a natural tendency for practices of exchange to emerge in human societies – a tendency illustrated by the story of Crusoe and Friday.

There is perhaps some connection with a contrast between the two writers' conceptions of freedom. For Hayek, the market order is compatible with individual freedom because of the impersonality and generality of its rules, and because the forces that determine prices are analogous to natural forces. Buchanan has a more first-person conception of freedom. 'Don't tread on me' is a demand that each person can make – the demand to be allowed to get on with their own life without interference. Suppose that Crusoe and Friday are about to make their first exchange. They do not perceive themselves as following any general rule; they are merely following impulses of normal human psychology. Imagine that a new castaway, Saturday, arrives on the scene and tries to prevent the exchange, perhaps

[5]In one of his retrospectives, Buchanan (1986a: 72) says: '[M]y emphasis has been on factoring down complex interactions into individual choice components and, where possible, to explain and interpret such interactions in terms of cooperation rather than conflict models'.

to put herself in a stronger position for bargaining with Friday. Buchanan would surely judge 'Don't tread on me' to be a natural and appropriate response to Saturday by Crusoe or Friday. As far as they are concerned, this really is all that there is to it.

5 | HAYEK'S BLIND SPOT

Recall that in *UoK* Hayek presents the market as a solution to *the economic problem that society faces*. But the idea that 'society' faces problems and looks for solutions is ambiguous – as Buchanan points out in his critique of Robbins's definition of economics (*WSED*: 214–215).[6] In his later work, Hayek sometimes appeals to imprecisely specified theories of social evolution and group selection in ways that suggest that the concepts of 'problem' and 'solution' are merely metaphorical. For example, he writes about 'rules of conduct' which have 'not developed as the recognized conditions for the achievement of a known purpose, but have evolved because the groups who practised them were more successful and displaced others' (Hayek, 1973: 18; see also Hayek, 1979: 159–161).[7]

In *LLL2*, however, Hayek works with a more contractarian conception of 'problem' and 'solution'. In the introduction to that book, Hayek says that he had felt it important to justify his critique of the concept of social justice – summed up in subtitle of *LLL2* as the claim that social justice is a 'mirage' – in relation to Rawls's (1971) then-recent *A Theory of Justice*. Hayek had concluded that the differences between him and Rawls were 'more verbal that substantial' (*LLL2*: xii–xiii). Later in the book, Hayek says that he 'has no basic quarrel' with Rawls, but merely regrets Rawls's use of the term 'social justice' (*LLL2*: 100). There are interesting echoes of Rawls throughout the book.

Look again at the passages from *LLL2* that I quoted in Section 2. Notice that Hayek is talking about *the aim of policy*, not about what has happened to evolve. He is advocating a policy of *using* spontaneously ordering forces rather than direct economic planning. The aim of this policy should be to *increase equally the chances for any unknown member of society of pursuing with success his equally unknown purposes*. So far, this might be read as a recommendation to someone in the role that economists standardly refer to as 'the policy-maker'. But notice also that Hayek says that he is recommending a policy that requires individuals to abide by the rules of the market, and that this is *the condition which alone will make it the interest of all so to conduct themselves as to make as large as possible the aggregate product of which they will get an unpredictable share*. In other words, he is recommending a set of rules which, if followed by everyone, will work in everyone's interests. This is contractarianism, as I understand the term.[8]

Hayek takes a further contractarian step by speaking about *agreement*. Considering a society whose members mostly do not know one another and have very different ends, he says:

> What makes agreement and peace in such a society possible is that the individuals are not required to agree on ends but only on means which are capable of serving a great variety of purposes and which each hopes will assist him in the pursuit of his own purposes.
>
> (*LLL2*: 3).

Sometimes (and more questionably), Hayek seems to suggest that this agreement has already taken place. For example:

[6]In a rare criticism of his admired teacher Frank Knight, Buchanan notes that both Knight and Milton Friedman ('men with whom, broadly and generally, I agree on principles of political-philosophical order') have used the idea of an economic problem for society in much the same way as Hayek (not mentioned by Buchanan) does in *UoK*. Buchanan acquits Knight, Friedman and Robbins of treating society as an organic entity, but thinks that the idea is dangerously ambiguous (*WSED*: 215).

[7]In Sugden (1993) I argue that Hayek does not develop a coherent theory of group selection and that his use of these ideas does not help his main lines of argument.

[8]See Sugden (2018, Chapter 3).

> It was the discovery that an order definable only by certain abstract characteristics would assist in the pursuit of a great multiplicity of different ends which persuaded people pursuing wholly different ends to agree on certain multi-purpose instruments which were likely to assist everybody.
>
> (*LLL2*: 4)

There is a similar suggestion in Hayek's moral stance towards the undeserved gains and losses that are an unavoidable feature of markets:

> It is precisely because in the cosmos of the market we all constantly receive benefits which we have not deserved in any moral sense that we are under an obligation also to accept equally undeserved diminutions of our incomes. Our only moral title to what the market gives us we have earned by submitting to those rules which make the formation of the market order possible.
>
> (*LLL2*: 94)

The thought seems to be that each of us, acting in our own respective interests and knowing that our expectations might be disappointed, has agreed to the rules of the market. If that disappointment materialises, we have no right to complain. The chapter of *LLL2* entitled ‘The market order or catallaxy’ ends with a particularly Rawlsian thought:

> The conclusion to which our considerations lead is thus that we should regard as the most desirable order of society one we would choose if we knew that our initial position in it would be decided purely by chance.
>
> (*LLL2*: 132)

But now the blind spot. Hayek is right to say that, in a market order, there cannot be *full* compensation for undeserved gains and losses: that would disable the incentive mechanism that is the market's motive power. But there is a trade-off between wealth creation and compensation: *partial* compensation can be combined with a weakened incentive system. If the aim really is to increase equally the chances for any unknown member of society of pursuing with success his unknown purposes, the economic system must not only provide individuals with opportunities to seek success; it must also give them some protection against the worst failures of those efforts. Hayek seems to recognise that fact but, in marked contrast to Rawls, does not see it in contractarian terms.

In *LLL2*, the main discussion of social insurance is in a short subsection, revealingly titled ‘From the care of the most unfortunate to the protection of vested interests’ (*LLL2*: 139–142). Hayek concedes that many early efforts to secure social justice were motivated by the ‘laudable desire to abolish destitution’. But, in developed market economies, the wealth-creating power of the market has abolished absolute poverty: ‘Nobody capable of useful work need today [i.e. in 1976] lack food and shelter in the advanced countries, and for those incapable of themselves earning enough those necessities are generally provided outside the market’ (*LLL2*: 139). Hayek gives his approval to public policies by which ‘a uniform minimum income is provided outside the market to all those who, for any reason, are unable to earn in the market an adequate maintenance’ (*LLL2*: 87).[9] He says very little about the justification for this minimal form of poverty relief, perhaps because he sees it as uncontroversial. (Its underlying principle had been recognised in England ever since the Elizabethan Poor Law of 1597.) He mentions two possibilities: ‘insurance against extreme misfortune may well be in the interest of all; or it may be felt to be a clear moral duty of all to assist, within the organized community, those who cannot help themselves’ (*LLL*: 87). However, the language of ‘care of the most unfortunate’, ‘laudable desire’ and ‘alleviation of the lot of the poor’ (*LLL2*: 139–140) suggests that Hayek

[9] Hayek is not (as some commentators have claimed) advocating a universal basic income or negative income tax. He is approving schemes which give an unconditional guarantee of *the opportunity to achieve* a minimum income. Normally, that opportunity is provided by the labour market; publicly funded support is to be provided only in response to ‘proved need’ (*CoL*: 301). For more on this, see Rallo (2019).

is thinking of the relief of poverty primarily as a moral duty of charity that falls on the non-poor, and which *they* may choose to collectivise.

Hayek returns to these issues in Volume 3 of *Law, Legislation and Liberty* (*LLL3*: Hayek, 1979). Here he argues that a public policy that assures a minimum income for all is essential for the political stability of a market society in which there is economic mobility:

> The assurance of a certain minimum income for everyone, or a sort of floor below which nobody need fall even when he is unable to provide for himself, appears not only to be a wholly legitimate protection against a risk common to all, but a necessary part of the Great Society in which the individual no longer has specific claims on the members of the particular small group into which he was born. A system which aims at tempting large numbers to leave the relative security which the membership in the small group has given would probably soon produce great discontent and violent reaction when those who have first enjoyed its benefits find themselves without help when, through no fault of their own, their capacity to earn a living ceases.
>
> (*LLL3*: 54)

As I read Hayek, he is thinking about risks of falling into absolute poverty that individuals would face in any society – the fate of 'the old, the physically or mentally defective, the widows and orphans' (*LLL3*: 53–54). In small-scale societies, these risks can be alleviated by informal practices of mutual aid, but a developed market economy requires more formal institutions.

What is missing is any sense that those who are unable to achieve a minimum standard of living have a legitimate claim on their more fortunate fellow citizens. Indeed, Hayek explicitly denies this in *LLL2*: 'There can be no moral claim to something that would not exist but for the decision of others to risk their resources on its creation' (*LLL2*: 98). But if the institution of a system of social insurance was part of an *agreement* to use the market, that agreement would create exactly such claims. If social insurance was partial (as it would have to be if the market were not to be completely disabled), these claims would sum only to some fraction of the value of what the risk-takers had created; but the claims would be morally valid. Hayek is not recognising the full implications of his conception of the market order as a social agreement.

6 | BUCHANAN'S BLIND SPOT

Buchanan is much more explicitly and consistently contractarian than Hayek. Undoubtedly, Buchanan's vision of the market pictures it in a favourable light. It is therefore surprising that he never develops a contractarian justification of the market. The closest he gets is in *The Limits of Liberty*, in which he gives a contractarian account of how transferable property rights might emerge by agreement from a Hobbesian state of nature (Buchanan, 1975: Chapter 2). But that is a justification of the market as superior to an equilibrium of predator and prey, not as superior to other forms of economic organisation.

Buchanan (1997) recognises the need for public policies that transfer income 'from the currently productive citizens to the aged and disabled' (pp. 165–166) and considers how constitutional constraints can reduce the scope for rent-seeking in majority voting about such policies. He argues that transfers should be financed by flat-rate taxes and should take the form of 'demogrants' – unconditional payments to classes of individuals defined by demographic criteria (for example, by age or disability, but not by means tests).[10] Significantly, however, Buchanan explicitly avoids 'justificatory argument' for welfare transfers as beyond the scope of his enquiry (p. 171). My sense is that for

[10]Buchanan's demogrant proposals are discussed in detail by Lehto and Meadowcroft (2021).

Buchanan, as for Hayek, welfare transfers are a necessary feature of a developed economy but are not fundamental to the justification of the market system.

But, quite apart from the issue of social insurance, the absence of a contractarian justification of the market is a surprising gap in Buchanan's work. I conjecture that the explanation for this gap can be found by looking at his and Gordon Tullock's founding contribution to the theory of public choice, *The Calculus of Consent* (*CoC*; Buchanan and Tullock,1962). This is a contractarian analysis of rules for collective decision-making. Buchanan and Tullock repeatedly argue that collective choice should be understood as the many-person equivalent of market exchange. In other words, their normative approach to politics is to treat politics as a kind of market. Thus:

> The market and the State are both devices through which co-operation is organized and made possible. Men cooperate through exchange of goods and services in organized markets, and such co-operation implies mutual gain. … At base, political or collective action under the individualistic view of the State is much the same. Two or more individuals find it mutually advantageous to join forces to accomplish certain common purposes.
>
> (*CoC*: 18)

And:

> We view collective decision-making … as a form of human activity through which mutual gains are made possible. Thus, in our conception, collective activity, like market activity, is a genuinely *co-operative* endeavour in which *all* parties, conceptually, stand to gain.
>
> (*CoC*: 266)

Responding to the apparent objection that unanimity in politics is an impossible ideal, they say:

> This line of reasoning seems quite plausible until one confronts ordinary economic exchange. Note that in such an exchange the interests of the two contracting parties clearly conflict. Yet unanimity is reached. Contracts are made; bargains are struck without the introduction of explicit or implicit coercion.
>
> (*CoC*: 250)

Following Knut Wicksell (1896/1958), Buchanan and Tullock treat the unanimity rule in politics as a normative benchmark. Less-than-unanimity rules are presented as variants that may be justified as means of economising on decision-making costs, but the unanimity rule is the ideal that would be appropriate in a counterfactual world in which decision-making costs were zero (*CoC*: 96).

In a contractarian analysis, a general rule is justified by showing that all members of the relevant society have good reason to agree that all of them will follow that rule. Typically, the agreement is supposed to be made behind some 'veil of ignorance' or 'veil of uncertainty' with respect to the cases to which the rule will be applied. Thus, when considering a possible rule, each contracting party has to trade off the expected benefits when the rule works to their advantage with the expected losses when it works to their disadvantage. But if the rule stipulates no more than that unanimously approved proposals are to be implemented, there is no downside risk. A contractarian analysis of such a rule would be redundant. Thus, *if it were true that markets operated as if by a rule of unanimity*, a contractarian justification of the market would be redundant too.

The problem is that this is not how markets operate. An exchange transaction requires the consent only of the owners of those goods or services that are exchanged. That no one has veto power over other people's transactions is crucial to the wealth-creating power of the market. As Hayek repeatedly points out, the market rewards individuals for discovering ways of benefiting their trading partners. If every member of society had veto power over every exchange, everyone would effectively own an equal share of the gains from trade from every transaction. The incentive to discover gains from trade would be lost.

The reality is that every transaction in a competitive market creates *pecuniary externalities* – benefits and costs that are transmitted through changes in market prices – to individuals who are not parties to that transaction. Valued in monetary terms and summed over all individuals, positive and negative pecuniary externalities are each of the same order of magnitude as the transaction that induces them. It is because the positive and negative effects of a transaction are equal and opposite – an implication of the tautology that every exchange involves both a buyer and a seller – that voluntary market transactions can be interpreted as wealth-creating. Pecuniary externalities are one of the main sources of the undeserved gains and losses that are an unavoidable feature of the market (Sugden, 2018: 188–189). For that reason, they are an instigation for many forms of protectionism which compromise the dynamism of markets. When advocates of the market oppose protectionist policies, they are rejecting the idea that the market should operate by a rule of unanimity.

Buchanan (1954b: 339, note 18) draws a better analogy between politics and the market when he describes the market as 'the only system of proportional representation which will likely work at all'. In politics, a method of proportional representation is a rule for choosing the composition of an assembly whose members are to represent the voting population. It is fundamental to proportional representation that relatively small groups of voters are able to choose their own preferred representatives, irrespective of the preferences of outsiders. Similarly, the market allows exchanges that have been agreed by the relevant trading parties even if, because of pecuniary externalities, other individuals would prefer those transactions not to take place.[11] This does not invalidate the conception of the market as a domain of voluntary interaction. Think of my story of Crusoe, Friday and Saturday. Saturday would prefer that Friday chose her rather than Crusoe as his trading partner. But if exchanges are to be voluntary, Saturday cannot demand that Friday trades with her.

A contractarian justification of the market is ultimately political (or, as Buchanan might prefer to say, constitutional). It is addressed to the members of a political community that has the collective power to choose the rules by which its economy will operate. It has to show each citizen that, all things considered, and over the long run, the market system that is being recommended can be expected to promote their individual interests. Each citizen can expect that, in a market system, they will sometimes gain from positive pecuniary externalities and sometimes lose from negative ones. Recognising this, each citizen might judge that their interests would be best served by combining the market with some form of social insurance.

7 | CONCLUSION

I see myself as a liberal economist, working in the tradition of Hayek and Buchanan. Like both of them, I see Rawls's account of justice as belonging to the same tradition.[12]

One of Rawls's most important ideas is that of *psychological stability*. Rawls requires that the governing principles of a well-ordered society are understood and accepted by its members. If this is to be the case, the hypothesis that individuals accept these principles must be consistent with the facts of human psychology. When an ongoing society is regulated by those principles, it must reproduce both a general belief that the principles are fair and a general willingness to abide by them. Principles that are self-reproducing in this sense are psychologically stable (Rawls, 1971: 16, 177, 453–462).

[11]Buchanan's (1965) theory of clubs shows how voluntary cooperation within a group of individuals can supply (excludable) goods that are consumed jointly by the group. Here too, and analogously with proportional representation, outsiders have no powers of veto.

[12]Hayek's favourable view of Rawls's work was discussed in Section 5. Buchanan (1986a: 72) recognises a 'basic similarity' between his approach and Rawls's and expresses 'an affinity with Rawls that has seemed mysterious to critics of both of us'.

I believe that Buchanan, Hayek and Rawls have provided three components of a liberal justification of the market that could be psychologically stable. In my own work, I have tried to integrate these components – with what success, others must judge (Sugden, 2018).

The first component is Buchanan's 'This is all that there is to it' conception of the market as a domain of voluntary interaction – a set of rules within which individuals are free to seek mutual benefit with willing cooperators. The second component is Hayek's conception of the market as a spontaneous order in which the actions of many individuals, equipped only with their own knowledge and seeking to achieve only their own ends, are coordinated in a way that creates aggregate wealth. The third component is Rawls's (1971: 84) conception of a society as a 'cooperative venture for mutual advantage'. If a political community chooses to use the market to organise its economic activity, it should do so on the public understanding that this activity is directed at mutual advantage.

As Hayek reminds us, an honest understanding of how the market works must recognise that rewards cannot be fully aligned with merit: there must be undeserved rewards and undeserved losses. But the principle of social insurance – that those who do least well from the market are entitled to some share of the wealth created by the more successful – is fundamental to the conception of the market as a cooperative venture.

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DATA AVAILABILITY STATEMENT

Data sharing is not applicable to this article as no new data were created or analyzed in this study.

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