IMAGINARY GOODS AND KEYNESIAN KALEIDICS: REJOINDER TO BRUCE CALDWELL

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ABSTRACT: In his reply to my critical book review, “Don’t Shoot the Messenger: Caldwell’s Hayek and the Insularity of the Austrian Project (Hill 2005),” Bruce Caldwell explains his decision to focus on Hayek’s methodological views, criticizes my account of Carl Menger’s “imaginary goods,” and rejects the line of reasoning I advanced drawing Keynesian conclusions from Hayekian premises. In response, I argue that Caldwell’s proposed methodology for assessing the significance of “imaginary goods” in advanced market economies is ill-conceived and that my pathway from Hayek to Keynes merely pursues a thoroughgoing subjectivism to its inexorable conclusion, which is not, as Caldwell suggests, counter-cyclical fiscal policy.
Bruce Caldwell suggests that his book, *Hayek’s Challenge: An Intellectual Biography of F.A. Hayek* (2004) may have been misunderstood by some reviewers (including this one) because it was published without his preferred subtitle, *F.A. Hayek and the Limits of Social Science*. Caldwell believes the original subtitle would have focused the reader’s attention more narrowly on the development of Hayek’s methodological views without creating the expectation that *Hayek’s Challenge* would provide a critical assessment of Hayek’s wide-ranging scheme of thought. In addition to giving us an intimate account of his intentions in writing *Hayek’s Challenge*, which Caldwell offers, in part, as a response to my complaint about the book’s lack of a critical dimension, Caldwell also takes the time to respond to a few of my substantive arguments, in particular those concerning “imaginary goods” and “Keynesian Kaleidics,” and it is these issues I shall focus on in my rejoinder.

I. MARKETS, SUBJECTIVISM, AND IMAGINARY GOODS

I found it surprising (and refreshing) that Caldwell defended Carl Menger’s distinction between “imaginary” and “non-imaginary” goods because this distinction presupposes an objective standard according to which the real value of goods can be judged. Whereas Menger was convinced that markets reduce the prevalence of “imaginary goods” over time, Caldwell allows that “the market process both creates and destroys imaginary goods all the time – sellers of snake oil are constantly with us, and some people are taken in, and then they and others who observe them can learn from the mistakes. Markets provide incentives both to generate such goods, and to identify them as such” (page 5, original emphasis).
In this proclamation, Caldwell takes a brave step outside the subjectivist camp, but immediately trivializes his transgression with his reference to “sellers of snake oil,” as if the problem of “imaginary goods” were confined to commodities peddled by con men and hucksters. In my review of Caldwell’s book, I cited research showing that increases in real income beyond a certain threshold have little effect on subjective well-being. My aim was to challenge the claim that markets reduce the number of “imaginary goods” over time by suggesting that the weak correlation between income and self-ascribed happiness may be explained, at least in part, by the persistence of “imaginary goods” in advanced market economies. Although Caldwell doesn’t share Menger’s optimism about the diminishing importance of “imaginary goods,” these research findings also jeopardize Caldwell’s implicit suggestion that “imaginary goods” lie at the periphery of the market economy. To be sure, Caldwell insists that studies of the relationship between income and happiness don’t “really establish much” and goes on to assert that “if one wants to know the effects on well-being of rising real incomes, a better test would be to reduce real incomes [in Japan] to one fifth of 1986 levels, and then see what people have to say about their subjective well-being” (p. 5, my stress). Caldwell concludes that “common sense as well as studies of loss aversion by behavioral economists, suggest that the pain would be great indeed” (p. 5).

This reply is deficient in two respects. In the first place, Caldwell gives us no reason to support his claim that the weak correlation between rising income and subjective well-being doesn’t “really establish much,” nor does he offer a convincing argument for his assertion that a reduction in income would provide a better test of the importance of “imaginary goods” than an increase in income. Pointing to our propensity
to care more about losses than gains ("loss aversion") does nothing to shore up
Caldwell’s claim that “imaginary goods” are small potatoes in a modern market economy.
It merely implies that people care more about keeping the goods they already possess,
*imaginary or not*, than they care about acquiring these same goods if they didn’t already
have them.¹ Second, Caldwell’s reply is off point: the issue isn’t whether citizens in
prosperous market economies would say they were “worse off” if their income were
sharply reduced, but whether they’d be happier if they had smaller money incomes but a
higher ratio of “real” to “imaginary goods,” say, for example, more leisure and less
expenditure on goods designed to improve their social status, expenditures which, if
undertaken by everyone, cannot achieve their aim.²

I share Caldwell’s view that markets provide incentives both to create “imaginary
goods” and to reveal their deficient nature, but I cannot resist the temptation to ask
whether the balance of market incentives favors the creation or the destruction of
“imaginary goods.” If Lexus advertises its luxury line of cars as symbols of “success,”
there may be gains in prospect for entrepreneurs who can show that such high-priced
“success symbols” are merely imaginary goods. But there are much greater gains
awaiting entrepreneurs (other automobile manufacturers in particular) who can persuade
car buyers that possession of *their* vehicles signals even greater “success.” If people
work longer hours in order to buy such status symbols, or to secure other “positional
goods,” which, by definition, cannot be made available to everyone, then we have at least
one plausible reason why increasing incomes haven’t generated corresponding increases
in subjective well-being.³
II. “KEYNESIAN KALEIDICS”

In discussing Caldwell’s account of Hayek’s evolving conception of equilibrium, I suggested that if Caldwell had paid closer attention to some of Hayek’s pivotal evasions, he might have uncovered a line of reasoning that proceeds from Hayekian premises (and methodological ones at that) to Keynesian conclusions. In appraising this line of reasoning, Caldwell writes,

“Anyway, if I understand Hill correctly, his claim is that Hayek’s work on how money as a loose link destroys the equilibrium of the market system, and his work on how the dispersion of knowledge raises the whole question of how social coordination can occur at all, should lead us directly to Shacklean kaleidics, and from there to Keynesian kaleidics, which I presume (perhaps wrongly) implies for Hill an argument in favor of Keynesian policy interventions” (p. 6).

This synopsis of my pathway from Hayek to Keynes is misconceived, and its “presumed” policy destination – Keynesian fine-tuning – lies at the end of a different line of reasoning. The most promising point of departure for this journey is Hayek’s conception of equilibrium, which is achieved when “every person’s plan is based on the expectation of just those actions of other people which those other people intend to perform” (Hayek 1937, 41). Although Hayek didn’t pay much attention to the conditions under which such an equilibrium was possible, he did allow that a disequilibrium could occur if “the prices existing when [market participants] made their decisions and on which they had to base their views about the future have created expectations which must necessarily be disappointed” (1935, 141).
This is a curious way of putting the matter: to speak of prices creating expectations. It is human beings who form expectations, so it seems odd to blame prices for generating expectations that go unfulfilled. Of course it is also human beings who set prices, and often on the basis of their expectations. And then there’s the inconvenient fact that there are very few futures prices, let alone prices for contingent commodities, e.g., a good that will be delivered on a particular date if it’s raining. So if a firm decides to build a factory, its managers must forecast the prices at which its output can be sold over the next ten or twenty years. In one way or another, this challenge faces anyone who makes a commitment the payoff to which will be determined by the future course of events. Moreover, the difficulty in making such predictions is compounded by the fact that “the future course of events,” including the time path of prices, will be determined in large part by the decisions, not yet made, of other human beings. Bearing these complications in mind, it seems clear that a state of disequilibrium, in which the plans of market participants are not mutually consistent and in which a great many expectations are disappointed, will be the normal state of affairs. And bearing in mind the thin, insubstantial, and fleeting basis of our predictions, it’s not surprising that these predictions, and the market conditions they influence, can abruptly change, in the manner of a kaleidoscope when it’s twisted.

Why didn’t Hayek come to embrace a “kaleidic” view of the market economy? Because he insisted that (apart from “monetary disturbances”) major disequilibria can only occur if entrepreneurs “all simultaneously make mistakes in the same directions” (Hayek 1935, p. 141). This proposition, which Caldwell glosses over without criticism, is wrong in every respect. Major disequilibria do not require that “all” entrepreneurs
make the same errors, only that a preponderance of them do. They do not require that all these errors be made “simultaneously”; history supplies countless instances in which waves of pessimism or optimism have swept over an economy at varying speeds. And the notion that “mistakes” or “errors” are the source of the problem is misleading insofar as it implies that market participants are trying to forecast an independent, objectively given set of variables rather than trying to guess what kinds of imagined scenarios are going to guide the decision-making of other market participants.

Caldwell’s response to my chain of reasoning is to point out that “Hayek’s views imply that the stability of the market process in any given instance is always an empirical question – empirical in the sense that the speed of adjustment will differ across markets” (p. 6). And he grants that “very slow adjustments certainly can occur, and have occurred historically, and these often have social costs associated with them” (ibid.). As I stressed in my review of Hayek’s Challenge, Caldwell is a sure-footed expositor of Hayek’s thinking and I have little doubt this is an accurate representation of Hayak’s views. But the more interesting question, for me at least, is whether this account stands in a coherent relationship with Hayek’s conception of an “expectational equilibrium.” If you think there’s a set of objective conditions that “holds still” while expectations and plans converge around them, then, leaving aside many other difficulties, markets may adjust in the manner Caldwell describes. But if you embrace a robust subjectivism in which imagination and choice play an essential part, then, alongside the ridged causal structures of nature, you must make room for a stream of self-originated and, therefore, unpredictable decisions, which are necessarily incompatible with a “Hayekian equilibrium” in which no one’s expectations are disappointed. Autonomy is a lovely
thing, but we must live with the consequences: it requires only the presence of others, with minds of their own, “to destroy the basis of demonstrably optimal choice” (Shackle 1988, 137).

Finally, I must add that Caldwell does indeed “presume wrongly” when he suggests that the foregoing line of reasoning leads me to favor “Keynesian policy intervention,” by which Caldwell means the kind of counter-cyclical fiscal policy, or “fine tuning,” that can only work if governments have extensive data about the state of the economy and can act quickly. Although I do not reject counter-cyclical fiscal policy out of hand – a massive public works program in the United States in 1931 would surely have been helpful – there are other, more attractive “stabilizers,” which are also appealing on other grounds. These include the progressive income tax, which reduces discretionary income during the “boom” while increasing it during the “bust,” and unemployment insurance, which has the same counter-cyclical effect. Another attractive vehicle for reducing income volatility would be the creation of “macro insurance markets,” which allow people to hedge against adverse circumstances they cannot control, such as a fall in the wages of their occupational group, a collapse of local real estate values, or a regional economy that underperforms the national economy. (see Shiller 2005).

In deference to Professor Caldwell’s special interest in Hayek’s methodological views, permit me to conclude by contrasting the illuminating ray that contemporary general equilibrium theory has cast upon real-world markets, on the one hand, with Hayek’s disinclination to develop the real-world implications of his own, highly provocative, “expectational” conception of general equilibrium, on the other. Although
the contemporary theory of general equilibrium is an abstract, mathematical specification of the exacting requirements that must be satisfied if resources are to be allocated efficiently, this ideal construction has also been deployed to show why real-world markets, such as the market for health insurance, cannot function in the manner of their ideal counterpart. The fact that each of us knows more about our own medical condition and medically-relevant habits than our prospective insurers – the circumstance known as asymmetric information – gives rise to the problems of adverse selection and moral hazard, which limit the range of mutually advantageous insurance contracts. Hayek, for his part, fashioned an enlightening and methodically subjectivist conception of general equilibrium that contemplates the perfect coordination of all individual plans. But he did not attend to the difficulties arising from the fact that since, in real world markets, there’s no pre-harmonization of plans before people act, the plans they carry out, or try to carry out, will be inconsistent with one another. I wonder what the trajectory of Austrian economics might have been – what new vistas of inquiry would have opened up, what policy recommendations might have emerged – if Hayek and his followers had appreciated the necessary and radical divergence between the ideal of a thoroughgoing consistency across all market plans and the disconcerting fact that real-world decisions are taken in ignorance of one another; if, instead of tracing all major disequilibria to “monetary disturbances” or other “distortions” originating in acts of government, the Austrian school had explored the complications created by the stream of spontaneous and unpredictable choices that are born in the subjective and disparate orientations of individual agents.
References


### Endnotes

1 I must leave it to Caldwell to reflect upon the question of whether markets populated by agents who assign more weight to their losses than to their gains still function in the way the Austrian School believes they do.

2 This argument is put forward in detail in Frank (2000). The issue is debated in Kashdan and Klein (2006) and Frank (2006).

3 The argument was originally advanced by Fred Hirsch (1978).

4 See also Hill (2004).

5 As Ludwig M. Lachmann observed, Hayek seemed to find expectations to be “of analytical interest only to the extent to which they converge,” ignoring almost entirely “the causes and consequences of their divergence” (1998, 59).

6 Caldwell is right to point out that imperfect markets aren’t necessarily inferior to poorly implemented government programs. I cannot give an adequate response to this claim here, but let me at least draw attention to one very large public program, Social Security, which allows for massive risk sharing that would be extremely difficult to achieve through private insurance (Diamond 2003). Reading the arguments advanced by Caldwell, as well as those put forward by the Public Choice School, one would expect that this program would be quite inefficient. But Social Security, in addition to virtually eliminating poverty among the elderly, has administrative costs that are about one-seventh per dollar of revenue compared with the administrative costs of private insurance companies (Diamond 2003). A mandatory social security program is less costly to run because it circumvents the problem of adverse selection and because it incurs no “selling costs.”