

## Markets, Information and Liberty \* (1)

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THE APPROPRIATE ROLE OF THE STATE in the economy and the effectiveness of markets in allocating economic resources has been a recurring theme in the literature since at least the time of Adam Smith (Caslin, 1987). Recently the advantages of a market system have been associated with the promotion of human liberty (see Britain, 1988, Dasgupta, 1989, and Hayek, 1967). This is an explicit departure from the line of thought, which defended markets in terms of efficiency. We shall argue that the efficiency approach cannot argue the case in favour of markets in an unambiguous way (Melck, 1987). More-over, we cannot escape the importance of value judgements in arguing the boundaries of state intervention. While welfare economics can give us some broad guidelines in assessing the importance of markets and determining the boundaries of state intervention, such guidelines of welfare economics should be integrated with certain views regarding information and human liberty.

### 1. The Market Efficiency Approach

The market efficiency approach defends the superiority of a market system in terms of its efficiency in allocating resources and we distinguish two schools of thought in this regard namely neo-classical analysis and the Austrian approach of Hayek.

#### *Neo-classical theory*

The neo-classical defence of markets is based on a static framework with instantaneous adjustments. Perfect competition plays an important part in the exposition. The perfectly competitive market is characterised by a large number of participants. Property rights are clearly defined and products are homogenous. There are no barriers to entry, constant returns to scale, and the

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relevant information is readily available and free of charge. Firms maximise profits by equating price to marginal cost while consumers maximise utility. A market system which satisfies these conditions is said to be efficient and is deemed to be desirable in terms of Pareto optimality. Although neo-classical economics deals explicitly with market forms such as monopoly and oligopoly we do not pursue this aspect of the analysis here since we concentrate on the neo-classical defence of markets in terms of efficiency which limits the exposition to the perfectly competitive model. Imperfect competition could be considered as a form of market failure as will be indicated below.

In the neo-classical approach market participants are price takers and the system is in need of someone to set prices. This function is performed by the Walrasian auctioneer who provides all necessary information free of charge.

The ambiguity of this paradigm in defending markets in terms of efficiency is evident in two areas. Firstly, the stringent conditions of a perfectly competitive market are not met in the real world and therefore (based on these criteria) markets are considered to have failed. Secondly, as the auctioneer provides information free of charge, his co-ordination of market activity implies that this activity could be conducted equally well by a central authority or planning agent. We are faced with a paradox, since the argument in favour of markets leads to the conclusion that they should be abolished. Furthermore, the translation of individual preferences to an overall social ordering in terms of majority voting is problematic since Arrow (1951) has demonstrated that such a translation is unlikely to be attained. In general there exists no social welfare function which could satisfy the Arrow conditions of universality, Pareto consistency, independence and non-dictatorship. This outcome is often referred to as the Third Fundamental Theorem of Welfare Economics which leads to the same argument as Arrow's Impossibility Theorem, from which it follows that we cannot escape the significance of value judgements in generating a social ordering from individual preference orderings. These value judgements are to be made by government. We have no guarantee that governments will have the information to make these value judgements effectively, and therefore governments may fail as indicated by Buchanan (1975 ch. 10). This means that planners may fail just as- markets will fail.

The neo-classical paradigm defends government interventionist policies in order to correct market failures, but such intervention may also fail. In arguing a case for government intervention to correct market failure, neo-classical economics is falling into the error of applying normative welfare economics as a positive theory (see Sandmo, 1990).

We can identify at least three broad categories of market failure, viz

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demand, supply and market structure failures (Helm 1989. Demand failures occur when individuals have insufficient information to rank all alternative choices in order of importance. The state may correct this by providing better information, but the most common practice is to alter or replace individual preferences in a paternalistic way. The most well-known examples of such actions are health care and social security. Preference failure could also be associated with the production of public goods. These goods exist where the marginal cost of another consumer is zero and there is no exclusion from consumption. The true demand for public goods is not

reflected in market variables and because of the non-excludability nature of these goods there is no incentive for profit maximising firms to supply them.

Supply failures are associated with externalities or the spill-over effects produced by certain goods. Externality arises when the production or consumption activity of one party becomes a variable in the production or utility function of another party. Pollution is a well-known example of such spill-over effects and they are also explained by the divergence between the private cost of production with that of society.

Market structure failure occurs in the presence of economies of scale which goes hand in hand with imperfect competition such as monopoly.

#### *The Hayekian Framework*

The Austrian defence of markets, as presented by Hayek, starts from a different angle. It stresses competitive processes but the exposition is independent of the perfect competition assumption. Hayek (1978) maintains that perfect competition could be associated with a static situation where all facts are known. This state of affairs leaves little room for competitive activity because competition is seen as a discovery procedure for the disclosure and co-ordination of preferences. Moreover, the adjustment process is analysed within the context of the individual firm and consumer, implying that it is very much an individualistic oriented approach. The market system is not defended in terms of efficiency but because of its superiority as a means of co-ordinating preferences non-coercively.

Gray (1989) has argued that this defence of markets is based on an argument associated with liberty and not primarily with welfare considerations. Within the Austrian approach, one could argue that market efficiency is likely to be improved by competition.

The Hayekian exposition supports the view of a limited state, since Hayek (1967) explicitly admitted the importance of the production of public goods. Hayek is therefore not propagating a minimum state, while his idea of limited

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government could be captured by the term *Rechtsstaat* where the coercive functions of government are limited to the enforcement of uniform rules of law (Hayek, 1967). Discretion in government interventionist action is excluded; intervention is governed by definite rules. Hayek's argument against intervention in markets is based on the view that such actions would distort markets and market co-ordination would fail. Large scale government intervention requires knowledge of market variables that are unknown to a single agency or authority and therefore government failure is immanent. More-over, he claimed that government failure could be worse than market failure. Gray (1989) showed that these arguments are not sufficient to stage a conclusive case against interventionism and therefore interventionist actions had to be considered on a case by case basis, particularly when market information happened to be distorted by externalities and other forms of market imperfection. Therefore Helm (1989, p. 21) concluded "Economic theory does not lead to a general presumption of either for or against the market system". We therefore do not escape the problem of value judgements regarding the role of the state, but within the Austrian approach we have made substantial progress in developing an analysis of markets within a dynamic framework.

## **2. New Activist and Liberal Views on the Boundaries of the State**

So far we have discussed the defence of markets in terms of the efficiency framework based on the perfect competition assumption of neo-classical theory and the dynamic competitive allocation process of Hayek. We have demonstrated the problem of a market as well as government failure and within the Hayekian framework it has been claimed that government failure could be worse than market failure. The final outcome of the analysis is that the economic borders of the state are not independent of value judgements, which implies that we are unlikely to achieve unanimity on where these boundaries are to be drawn (Helm, 1989 and Beckerman, 1989).

This section deals with two approaches in favour of markets but both are more explicit on value judgements. We distinguish the view of activist economics, as for instance analysed by Levinson (1988), and the liberal defence of markets. In this context "liberal" refers to the European interpretation of the word, which emphasises personal freedom. The first approach is a pragmatic one in the sense that state intervention is presented as a working hypothesis rather than the outcome of a formal analysis. Although these authors give little support for the conventional

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welfare state with extensive interventionist policies, they argue a strong case for limited government intervention in a market economy, while discarding the popular freemarketeer arguments in favour of markets. We are not analysing the freemarketeer defence of markets since we regard this as a popular and probably simplistic effort which is usually based on a misunderstanding of Adam Smith and *laissez faire*, as is evident from an extensive analysis by Viner (1960). This approach differs in one important respect from the Hayekian analysis and the liberal approach which shall be discussed below. It leans towards discretion rather than rules (Levinson, 1988, p.174). It challenges the perfect competition assumptions of the neo-classical efficiency arguments in favour

of markets and concentrates on market imperfections which require corrective actions by government.

We shall now concentrate on the liberal defence of markets (Brittan,1988 and Dasgupta,1989) which follows the Hayekian route in linking markets with liberty, while value judgements feature explicitly in the analysis, particularly in the primacy of liberty. Like the Hayekian exposition this approach is strongly in favour of limited government. A particular feature of the analysis is the reconciliation between liberty and market efficiency. The liberal approach depends heavily on the distinction between negative and positive liberty (Berlin, 1969, pp.122-34). The central role of liberty in this exposition emphasises the importance of the individual. *Negative freedom* refers to the absence of coercion which means that a person is free to the extent that no one else interferes with his activity (Brittan,1988, p. 35). *Positive freedom* refers to the ability of a person to be somebody, not a nobody and it is concerned with the ability of a person to function, i.e. it refers to living standards (Dasgupta,1989, pp.114-115). Dasgupta (1989) introduced the concepts of positive-rights goods and negative-rights goods. The first category refers to those goods which enable a person to function, i.e. goods such as basic food and shelter, medical care, primary education and sanitation facilities. Negative-rights goods comprise security and an effective legal system. Negative freedom is associated with the efficiency of markets and this form of liberty ties in with the neo-classical and Hayekian analysis of efficient markets. Market failure would be corrected by the production of public goods and since negative freedom is largely determined by the production of negative-rights goods, which are typical public goods, government intervention could enhance welfare. A "corrected" market economy would secure a combination of freedom and prosperity (Brittan,1988, p. 63). It is envisaged as a system where policies are followed to provide a suitable environment to support the functioning of the market and to deal with discrepancies between private and social costs and benefits (Brittan,1988, p. 52). The extent of the correction is

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determined by value judgements.

The liberal view follows Hayek in defending government intervention in terms of rules rather than discretion, since discretionary powers could increase the possibility of government failure. Moreover, adhering to rules would be consistent with the emphasis on the absence of coercion. Emphasising rules for government intervention does not prevent government from supplying certain goods and services, but the state should not have a monopoly in any of these fields of production (Hayek, 1967). Government intervention in terms of rules implies that market participants are in a position to discover the rules of the game, which implies less uncertainty.

The liberal defence of markets proposes *limited* as opposed to *minimum* government. The size of government should be restricted in terms of certain accepted value judgements. In contrast with the efficiency exposition of neo-classical economics, the liberal view can accommodate distribution issues, and the two concepts of liberty are important in this analysis.

Pareto optimality does not guarantee that the distribution pattern meets social justice, and as opposed to neo-classical economics this problem is explicitly pursued by the liberals. Consider a two-person society where the one starves and the other possesses everything. We could claim a Pareto optimum in the sense that we cannot improve the position of the one without affecting that of the other adversely. We have attained efficiency since the Pareto condition is satisfied, but the equity aspects of this example are appalling. Dasgupta (1989) indicated that commodity allocations may yield identical welfare assignments but we cannot be neutral towards these assignments if the negative and positive rights goods in them differ significantly. Market failure could be present in the production and consumption of positive-rights goods. This set of goods contains private and public goods. Competitive markets can attain an efficient allocation of private goods but cannot guarantee an allocation of these goods in a way which ensures the protection of positive freedom to all members of society (Dasgupta,1989). State intervention is therefore defended in the sense that it should guarantee individual access to positive-rights goods to ensure a reasonable standard of living. It stands to reason that value judgements play an important part in this assessment.

In the liberal defence of markets, the problem of distribution has become an important element of the analysis, while the efficiency aspects of markets have not been overlooked. Moreover, this approach follows Hayek in emphasising liberty in the analysis of allocation and distribution issues of markets. The linkage between markets and human liberty will be discussed in more detail below, but within a different context.

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### 3. Markets and Information

The problems with the neo-classical paradigm forces one to examine old established concepts in a more critical way because they could be related to what Hayek referred to as "uncritical application of habits of thought to fields different from those in which they have been formed" (Hayek, 1989, p. 3). We have constructed mental systems associated with human behaviour in an imperfect world as if we were dealing with a perfectly working system. Such a mental framework defends markets in a negative way and market failure became a prominent feature of the analysis. The negative defence of markets is an unfortunate position since markets

are defended in terms of a theoretical framework which has little relevance in explaining the real world. Moreover, the assumptions supporting the theoretical defence of markets are unlikely to be met in the real world and markets are bound to fail. This is a negative approach. Unfortunately the "corrective" market approach through state intervention could also be classified as a negative one, since government failure supports the argument of limited government. These mental constructions are to a large degree the outcome of the neo-classical analysis and we could probably make more progress in our understanding of these problems by exploring the Austrian route.

In Austrian economics markets are part and parcel of a dynamic framework of human behaviour and therefore the events in markets are associated with time. It is the importance of time which encouraged this school of thought to view markets as processes. Lachmann (1986, p. 4) emphasised this as an important property of markets because processes are associated with dynamic forces and markets are known for ongoing processes as opposed to a static *framework* lacking such elements. Markets are characterised by equilibrating as well as disequilibrating forces. Even if they clear, this situation can hardly be described as a state of permanent rest (Lachmann, 1986, p. 7). Competitive market forces cause dis-coordination as well as coordination of economic plans. Markets are associated with processes of a discovery nature (Hayek, 1978). Moreover, the coordinating and dis-coordinating process could result in spill-over effects from one market to the other. The most important common denominator of the processes and functions described above is the dissemination of information. In the efficiency approach markets merely perform an allocative role. The information aspect is particularly important if we abandon the Walrasian approach. (See for instance Hayek, 1937, Torr, 1980, Lachmann, 1986, ch. 3, Stigler, 1961 and Strydom, 1986.) Information is important because market participants live in an uncertain world and therefore they have plans. Following Lachmann (1986, pp. 118-119) we define a

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plan as a web of thought which accompanies and guides observable action. A plan may be put into practice or it may be modified because of new information and in certain instances the information could change radically and a particular plan may be abandoned. In the static world of instantaneous adjustments, plans are not needed. Within this dynamic framework the dissemination of information by markets is of prime importance. Hayek (1978) usually associates information with price information but markets may also have relevant information about other institutions in society. This information enables market participants to draw up plans to make decisions. Market participants utilise market information (primarily price information) to attain their goals more or less successfully. We have entered the problematic area of efficiency. In this micro-economic framework we could identify a weak condition for efficiency in the sense that the individual market participants could attain equilibrium over the short term by maximising their own utility. Markets are social institutions, which disseminate price information. This process may not be efficient across the board but in terms of our weak condition of efficiency there could be markets and individuals attaining partial equilibrium in the short term. This is a positive defence of markets within a dynamic framework similar to that of Hayek since markets are assumed not to fail. We defend markets as social institutions, which are characterised by processes with spill-over effects and in this dynamic framework they disseminate information. Our exposition is not dependent on static assumptions, which necessarily lead to market failure. We therefore characterise our approach as a positive defence of markets as opposed to the neo-classical negative defence of markets.

Within our dynamic framework the conventional efficiency condition is met only occasionally and uncertainty is a permanent element. Market participants are therefore forming expectations. Speculators play an important role in markets because they base their plans on expectations regarding the likely outcome of information. Excessive speculation could cause instability, which means that disequilibrating forces tend to override equilibrating forces. In the neo-classical approach equilibrating forces override disequilibrating forces. Markets in which the disequilibrating forces are dominant cannot disseminate information effectively. The disseminating function of markets could also be affected detrimentally by inflation. Distorted information in the sense of highly inflated prices cannot assist market participants in formulating plans of action.

The challenge to government is to protect markets as a social institution in order to enhance the effective dissemination of information. Markets should be protected from conditions in which the disequilibrating forces dominate.

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(In the extreme sense markets could break down under the force of the disequilibrating forces - see Hicks, 1946, pp. 45-57.) This could be done through the creation of supportive institutions such as international agreements on *policy co-ordination* to stabilise foreign exchange markets. Moreover, an *anti*-inflation stance by government is imperative since inflationary pressures affect the reliability of price information which makes nonsense of the dissemination process and thus of markets.

We envisage a positive role for government in enhancing and supporting the process of the dissemination of information and follow the liberal defence of markets by leaning towards rules rather than discretion.

#### 4. Markets and Liberty

We have argued a positive case for markets and thereby escaped the efficiency failure critique while claiming the attainment of weak efficiency conditions. In this section we extend the analysis to society as a whole. Information remains a key concept in our exposition. Market or price information in particular, is important for society since it supports human liberty, particularly in the negative sense because in the non-coercive framework of liberty, people have the possibility of doing their own thing (Buchanan, 1975, p. 20). Market participants should be able to make decisions regarding the ordering of their preferences, the priority of their want satisfaction, the distribution of their time between work and leisure, the type of career that they want, and the place where they want to live and work. Decisions regarding such (and other) preferences are dependent on information and markets are important in supporting human liberty by providing information. We have emphasised the importance of price information at the micro-level and although this would still be the case at the aggregated level, markets also disseminate information of relevance to other social institutions.

We should create an environment which is conducive to the functioning of markets because by disseminating information effectively they enhance human liberty. Our argument is similar to that of Hayek since the defence of markets is associated with liberty rather than welfare. Government intervention plays an important role by supplying negative-rights goods, and by doing so enhances the function of markets, and thus promoting human liberty. We support the liberal defence of markets in the sense that the provision of negative-rights goods should be conducted by rules rather than discretion. Discretionary policies encourage the growth of government regulations which introduce rigidities into the market system and disrupt the process of information dissemination. Jones (1987, ch. 5) argues that sustained economic

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expansion in Europe is explained by the abolition of regulations which discouraged markets. Europe 1992 should be seen as a grand effort to enhance markets, to abolish distorting regulations and to make markets more successful social institutions which disseminate information in support of human liberty (Cecchini, 1988).

In the neo-classical approach certain vital elements of information are not disseminated by markets. The goods concerned are important because they determine equity considerations. The production of positive-rights goods goes hand in hand with value judgements since they are directly related to standards of living (Dasgupta, 1989). Moreover, this set of goods comprises public and private goods. This is probably the most controversial and complicated case in favour of government intervention because we do not have sufficient market information regarding the production or withholding of certain goods. The provision or withholding of these goods by the public sector relies on value judgements. The explicit emphasis on positive-rights goods provides a systematic approach to the problems of distribution and equity. Viner (1960, p. 68) has pointed out that a free or competitive market system, which ignores or opposes measures in the field of distributive justice "would seem to be glaringly unrealistic with respect to its chances of political success . . ."

The choice of the basic social goods should be made through the political process rather than through paternalistic state selection. In many instances the political process has been ineffective or non-existent and therefore paternalistic state decisions regarding these social goods have played too important a part.

## 5. Applications

The above framework could prove helpful in guiding our thoughts on present day problems regarding the boundaries of the state. Nationalisation of certain South African industries has recently been widely discussed. The economic rationale for nationalisation is complex, covering arguments such as market failure, monopoly, economic planning, union participation and control, and cross-subsidisation. Moreover, as indicated by Brittan (1988, p. 71) the empirical evidence on the failure of nationalised industries in Britain is ambiguous, because it depends on the type of industry and other circumstantial evidence.

Nationalisation will no doubt expand rigid bureaucratic processes and in terms of our analysis this is likely to disrupt the information disseminating process of markets. Nationalisation is unlikely to be successful in enhancing

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human liberty since its organisational character contradicts one of the basic fundamentals supporting human liberty. It is clear that nationalisation contradicts one of the major aims of a new South Africa, namely the enhancement of human liberty.

There is one common element in all the different approaches, which we have discussed so far and that is that competition enhances efficiency. As indicated by Helm (1989), the reasoning behind nationalisation is based on a confusing argument since it implies that state ownership of resources could enhance the effectiveness of the economic system, whereas our exposition and the evidence on nationalised industries suggest that competition is an important aspect of efficiency. Nationalisation is unlikely to be a successful force in shaping the future of South Africa, since the key to a more effective system is not determined by ownership but by competition.

The new developments in welfare economics appear to be far more explicit in accepting the *importance* of value judgements in

determining the borders of the state. We have seen that these value judgements are of particular importance in issues of redistribution and social justice. The provision of and access of people to positive-rights goods is likely to become a more important aspect of South African economic life. We have already indicated the importance of the political process in determining the public choice regarding these goods. South African society has been characterised by paternalistic state selection of these goods. The emphasis of political organisations on redistribution issues should be regarded as a serious plea against an outdated system of paternalistic state selection of positive-rights goods.

Welfare economics could play an important part in giving broad guidelines in this selection process. In this regard we would like to emphasise the importance of a redistribution of skills as a major human and economic resource. This means that the reorganisation of our educational system into a uniform single system with equal access to every South African citizen should be a major priority in making positive-rights goods accessible to everybody. Education as a positive-rights good should be made available on a large scale by government in order to address distributional problems.

The effective redistribution of skills through education will have positive spill-over effects from the area of positive-rights goods to the overall efficiency of the economy. A reallocation of skills through educational reform will enhance positive freedom but the spill-over effects will advance negative freedom, therefore supporting human liberty in a general sense.

Since the early 1980's South African authorities have tried to promote a market orientated approach. The liberalisation of financial markets and the introduction of a more flexible exchange rate system, together with a market

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orientated monetary policy, were probably some of the major achievements of this new approach. Unfortunately these reforms were based on intellectually confusing arguments, which rendered them somewhat ineffective. As these reforms were introduced, the political rhetoric started emphasising the importance of progress in terms of human liberties. Unfortunately the politicians were reluctant to implement these reforms and we ended with serious contradictions in the sense that we encouraged the establishment of markets, particularly financial markets, but contradicted this with political rigidities, particularly regarding the mobility of people. Markets serve human liberty, and if we are serious about the development of a market system we cannot maintain a disruptive political system. There are several reasons why our foreign exchange market collapsed during the 1980's, but our analysis suggests that the contradiction between the expansion of markets within a politically rigid system implied a major contradiction which triggered the collapse of the foreign exchange market.

Our analysis demonstrates the importance of an anti-inflation policy. One of the major lessons from the economic policy failures of the 1980's is that one cannot promote markets within a double digit inflationary environment, and the presence of such a contradiction could easily lead to a market collapse.

## 6. Conclusion

Neo-classical welfare economics cannot defend markets in an unambiguous way and economics has probably suffered in accepting that governments would have perfect information in allocating resources. Unfortunately we had to learn that these benevolent despots failed as well. Neo-classical welfare economics was reluctant to accept the practical importance of value judgements, particularly in the area of distribution and equity, and it is probably because of this attitude that the welfare state emerged without economic rationale.

The new contributions to welfare economics are to a certain extent an extension of the Hayekian framework but concentrate more explicitly on distribution issues through a distinction between negative and positive freedom which in turn corresponds with negative-rights and positive-rights goods.

The neo-classical approach has too narrow a view of markets. In the Austrian approach, the dissemination of information is of paramount importance. It enables us to identify weak conditions of efficiency and to escape the market failure syndrome.

Markets which disseminate information support human liberty since negative freedom implies individual decision making which is dependent on information.

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State intervention should primarily be concerned with the creation of institutions which could support markets in disseminating information effectively.

Equity considerations regarding redistribution are explicitly included by following a positive-rights goods analysis as it has developed in modern welfare economic theory. Value judgements feature prominently in this exposition while an effective political process could play an important part in substituting public preference for paternalistic state selection.

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## Endnotes

**1**

Presidential Address to the Economic Society of South Africa at its 63rd Annual General Meeting in Pretoria on 3 September 1990.

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