

F. A. Hayek and the
World of Tomorrow:
The Principles of
International Federalism

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Abstract: In a small number of texts written in close proximity to World War II, Friedrich A. Hayek describes his ideal international order as a union of sovereign nation states that confers upon its members the freedoms and material benefits of a common market. An important objective of this “interstate federation” is to secure peace. Hayek also discusses two additional arguments in favor of international federalism. First, he argues that inter-jurisdictional competition within a federation protects free markets and limits the scope of discretionary economic policy. Second, he maintains that a federal structure helps to align the actions of government with the interests of voters, thus realizing the true democratic ideal. The present paper sketches the historical development of Hayek’s proposal. It then describes his theoretical arguments for (international) federalism and highlights the relationship of these arguments to more recent scholarship in the fields of public finance and public choice. In closing, the paper underscores that Hayek’s writings on federalism are part of his attempt to formulate a positive liberal agenda.

INTRODUCTION

Friedrich A. Hayek was a foremost exponent of liberalism¹ in the 20th century, particularly of the neoliberal movement which began in the 1930s. Contrary to the representatives of 19th century *laissez-faire* liberalism, the neoliberals thought that the functioning of markets requires an institutional framework geared towards upholding competition (Burgin 2012). This position begs the question as to what kinds of institutions support markets and how they can be established.

Hayek acknowledged the possibility of rationally identifying and implementing market-supporting institutions. But he also expressed the view that many such institutions were in fact the result of a long-standing evolutionary process (for a discussion, see Vanberg 1994). Without going into detail on these two possibilities, it can be said that Hayek was very cautious about making concrete proposals for institutional reform.

This paper aims to draw attention to one of the very few instances where Hayek made an institutional reform proposal, namely his discussion of federalism.² The proposal contains two distinct elements. On the one hand, Hayek analyzed the properties of federalism as a mode of government. This part of the discussion has indirect implications for reform. On the other hand, he recommended adopting

federalism as a supranational governance system either on the world scale or on a smaller scale, thus creating “a true international law which would limit the powers of national governments to harm each other” (Hayek 1979, p. 149).

Federalism refers to the division of functions between two or more levels of government. Hayek’s perspective on federalism is usually considered as an early example of the “Leviathan” view of the state, which suggests that a federal government structure can be used as a commitment device against excessive taxation and regulation (Kantorowicz 2019; Rodden 2006). As emphasized by this paper, his discussion also contains a second important argument about how federalism improves democratic decision-making.

Hayek developed his view on federalism in a small number of texts written in close proximity to World War II. The first such text, “The Economic Conditions of Interstate Federalism” (Hayek [1939] 1948), was published in September 1939, the same month that Germany invaded Poland. During the war years, Hayek connected his discussion of federalism with the fate of Germany after her defeat. He proposed that the *Reich* should be broken up into its individual states and then integrated into a European federation (Hayek [1944] 1992; [1945] 1992).

As can be seen, Hayek thought of federalism as a means to further the goal of international integration. In 1939, he described his ideal international order as a union of unspecified nation states – an “interstate federation”—which confers upon its members the benefits of a common market, including the free movement of people. He assumed that the states within the union would need to conduct a common monetary policy (Hayek [1939] 1948, pp. 258-260). Unsurprisingly, Hayek’s description of an interstate federation has been compared to the setup of today’s European Union (e.g., Höpner and Schäfer 2012).

Hayek viewed the goal of international integration as essential to liberalism. He maintained that “the abrogation of national sovereignties and the creation of an effective international order of law is a necessary complement and the logical consummation of the liberal program” (Hayek [1939] 1948, p. 269) and that the ideals of “real liberalism” are “freedom and internationalism” (p. 271). He shared this outlook with his colleague Lionel Robbins, who argued in favor of a “liberal world federation” (Robbins 1937, p. 247). Other proponents of liberal internationalism in Hayek’s circle included his teacher Ludwig von Mises (Rohac and Mingardi 2021) and the ordoliberal social philosopher Wilhelm Röpke (Kolev 2021).

Hayek was of the persuasion that liberalism and nationalism are generally incompatible. While the liberals of the 19th century aligned themselves with the nationalist doctrine, he believed that the experience of the early 20th century had shown that nationalism endangers both individual freedom and liberal democracy (Hayek [1939] 1948, pp. 270-271). Hayek expected an interstate federation to mitigate the threat of nationalism because it establishes a supranational authority that limits the power of the nation state over the individual (Hayek [1944] 2007, pp. 232-235).

The present paper sketches the historical development of Hayek’s federalism proposal. It then describes his theoretical arguments for (international) federalism and highlights the relationship of these arguments to today’s public finance and public choice literature. In closing, the paper underscores that Hayek’s writings on federalism are part of his attempt to formulate a positive liberal agenda.

THE HISTORICAL DEVELOPMENT OF HAYEK’S PROPOSAL

Hayek apparently first became interested in the international dimension of liberalism through Robbins (Spieker 2014). Robbins, in turn, believed that the ideal extent of international integration was prescribed by the principle of federalism.³ During the late 1930s, both Hayek and Robbins were members of the Federal Union, a British advocacy group that promoted the idea of a federation of European states (Rosenboim 2014).

In line with his involvement in the Federal Union, Hayek’s 1939 paper “The Economic Conditions of Interstate Federalism” combined an academic discussion of federalist principles with the political plea for international integration through federalism. Naturally, with the beginning of WWII, such ambitions had to be put on hold.

As the Allied forces came closer to victory against Nazi Germany, Hayek began applying his considerations on federalism to the situation at hand. There were two ways in which federalism could play a role in the post-war world. First, as Hayek already noted in a 1944 speech given at King's College Cambridge, a federal structure could be used as a check on government power in the defeated Germany (Hayek [1944] 1992). Second, long-term political order on the continent could be secured by means of a future European federation.

In *The Road to Serfdom*, Hayek tackled the question as to what an international federation could look like in practice. He distinguished between more integrated “regional” federations with a smaller number of constituent countries and less integrated (“looser”) associations of many countries, possibly the whole world (Hayek [1944] 2007, pp. 235-236). Hayek particularly thought that a close partnership would be possible between the United States and Western Europe (p. 235). After the end of WWII, he envisioned the formation of two or more European federations which could merge into a single federation at a later point in time (Hayek [1945] 1992, p. 226).⁴

Regarding Germany's political system, Hayek argued that the country should also become a federation, or possibly confederation. While the central government needed to remain under Allied control for the time being, a large degree of independence could be given to those German states that developed democratic institutions (pp. 224-226). Hayek initially published this “Plan for the Future of Germany” in a 1945 newspaper article. He reiterated the plan in his introduction to Röpke's *The German Question* (1946), a treatise that linked the centralization of Germany under Otto von Bismarck with the rise of Nazism.

The plan further proposed that when Allied control over the German states became unnecessary, they could be integrated into a European federation. The prime objective of this arrangement was to impose free trade on Germany. Hayek hoped that the economic entanglement of the German states with their neighbors would counteract tendencies of centralization and aggression (Hayek [1945] 1992, pp. 226-227). In this way, federalism would help to secure peace in Europe. The “Problems and Chances of European Federation” were also a topic of discussion at the foundational meeting of the Mont Pèlerin Society in 1947.⁵

Quinn Slobodian (2018) posits that Hayek's work on federalism eventually became part of a larger post-war neoliberal project to free markets from political constraints. In his view, the 1939 “interstate federalism” proposal was put into action with the 1957 Treaty of Rome that established the European Economic Community. While Slobodian does not claim that Hayek wanted to bring about the EU, his argument is that architects of European integration such as Hans von der Groeben and Ernst-Joachim Mestmäcker were influenced by Hayek's and Robbins' ideas (pp. 207-210).

Slobodian credits Hayek and Robbins with conceptualizing an international body of law that enforces the separation between *imperium* and *dominium*, i.e., between nation states on the one hand and the (borderless) market economy on the other hand.⁶ It is unclear, however, whether this representation captures the essence of Hayek's proposal. As Slobodian himself points out, Hayek's proposed federation must be understood as a constitutional arrangement (p. 214). Thus, rather than separating markets and politics, Hayekian federalism is based on a *prior* political decision.

TWO ARGUMENTS IN FAVOR OF (INTERNATIONAL) FEDERALISM

As we have seen, Hayek thought that an interstate federation would help to secure peace in post-war Europe. Yet, his 1939 paper—which constitutes the analytical core of his writings on federalism – focuses mostly on two different theoretical arguments. It should be noted that while these arguments were developed in the context of international federalism, they apply equally to federalism within the nation state.

Hayek's first argument in favor of international federalism is that inter-jurisdictional competition within a federation protects free markets and limits the scope of discretionary economic policy. As observed in the literature, this argument seems to be based on the assumption of “Leviathan-type” politicians who pursue their own private interests rather than the public interest (Kantorowicz 2019; Rodden 2006).⁷

Hayek asserts that if people, goods, and capital can move freely between the different states of a federation, the policy options available to these states will be more limited than the policy options available to a single unitary state that occupies the same territory. The reason is that people can avoid unwanted policies when making decisions regarding their location, consumption or investment (Hayek [1939] 1948, pp. 258-261).

The text offers two examples of this kind of inter-jurisdictional competition. First, Hayek explains that the federation's states will no longer be able to protect their industries by manipulating prices, because "any change in any part of the Union in the conditions of production of any commodity which can be transported to other parts will affect prices everywhere" (p. 259). Second, in the area of fiscal policy, opportunities for taxation will be more limited because "the greater mobility between the states [would] make it necessary to avoid all sorts of taxation which would drive capital or labor elsewhere" (p. 260).

In this way, the creation of a single market combined with the free movement of people provides a safeguard against excessive regulation and taxation. What is more, Hayek emphasizes that free trade within the federation also prevents the abuse of *private* economic power, such as attempts to monopolize or cartelize an industry (p. 261).

Hayek's second argument is that a federal structure helps to align the actions of government with the interests of voters, thus realizing the true democratic ideal. More specifically, he posits that federalism leads to collective decisions that serve the common interests of all citizens, rather than the interests of smaller groups. In line with authors such as James Madison or Lord Acton, Hayek views federalism as a check on the majority principle.

The second argument builds on the assumption that federations tend to be larger than unitary systems and/or encompass more heterogeneous populations. Additionally, it makes reference to a particular definition of what is meant by democracy, which Hayek takes from Acton. The latter defines the "true democratic principle" as the notion "that the free will of the collective people shall be fettered in nothing" (Acton, cited in Hayek [1944] 1992, pp. 212-213). Note that Acton suggests that democracy advances the will of the collective people, i.e., all people.

In the 1939 paper, Hayek says that "the realization of the ideal of an international democratic order demands a resuscitation of the [democratic] ideal in its true form", which he calls "government by agreement" ([1939] 1948, p. 271). The reason is that, in a federation with many different interests, it will be difficult to form a majority for legislative measures that benefit only certain groups or regions (e.g., a tariff that protects a particular industry). Thus, in a large and diverse federation, the task of the central government will be confined to measures that serve the interests of all citizens (pp. 261-266).⁸

It is particularly this second argument which leads Hayek to predict that, in an interstate federation, there will be less government overall. If an issue requires legislation at the central government level—such as a protective tariff—but agreement cannot easily be reached, there will be no legislation on this issue. Indeed, Hayek maintains that "this readiness to have no legislation at all on some subjects rather than state legislation will be the acid test of whether we are intellectually mature for the achievement of suprastate organization" (p. 266).

HAYEK'S PROPOSAL AND MORE RECENT SCHOLARSHIP

The possible advantages of federalism are referenced again in Hayek's later works, such as *The Constitution of Liberty* (Hayek 1960 [2011], pp. 274-275) or *Law, Legislation and Liberty* (Hayek 1979, pp. 45-46, 149). However, their mention is brief and it cannot be said that Hayek continued to develop his views on federalism in the post-war era.

During the 1950s, fiscal federalism emerged as a subfield of public finance which was concerned with the optimal level of (de)centralization of state activity.⁹ In an early seminal contribution, Charles Tiebout (1956) argued that local public goods provision is most efficient if individuals can choose between different bundles of taxes and public goods. The idea is that if municipalities are legally enabled to offer such bundles,

individuals will move to the municipality that provides the utility-maximizing combination of taxes and public goods for them.¹⁰ A more general theorem on the question of decentralization was formulated by Wallace Oates (1972).

While the Tiebout model bears a resemblance to Hayek's description of inter-jurisdictional competition, the traditional fiscal federalism literature differs from his approach in the important respect that public policy is ultimately assumed to be welfare-enhancing.¹¹ Hayek, on the other hand, viewed federalism as a way for citizens to avoid or prevent policies that are not in their best interest.

A perspective more closely aligned with that of Hayek was taken by the representatives of public choice theory. Geoffrey Brennan and James Buchanan (1980) characterize federalism as a constitutional constraint on a revenue-maximizing Leviathan government.¹² In line with Hayek's first argument discussed above, they state that "interjurisdictional mobility of persons in pursuit of 'fiscal gains' can offer partial or possibly complete substitutes for explicit fiscal constraints on the taxing power" (p. 184). Beyond the issue of taxation, Barry Weingast's (1995) theoretical and historical analysis of "market-preserving federalism" draws explicitly on Hayek ([1939] 1948).

Hayek's second argument from the 1939 paper—that federalism acts as a check on the majority principle—has generally received little attention (for an exception, see Streeck 2014). It is, however, part of a large literature going back at least to Madison's "Federalist No. 10" ([1787] 2012) that investigates the effects of multiple checks and balances on policy outcomes. In recent years, this literature has adopted the game-theoretic framework of veto power (Tsebelis 2002) to describe the kind of decision-making barriers envisioned by Hayek.

Lastly, it might be argued that the anti-nationalist thrust of Hayek's proposal is reflected in the concept of a new federalism with competing and functionally overlapping jurisdictions (Frey and Eichenberger 2001). The concept is based on the notion that states have two distinct tasks. They are "territorial enterprises" that rule over a land, but also "club enterprises" that provide benefits to their members. The difference is that club members do not need to be present on the state's territory (Vanberg 2016). This perspective points to the possibility of unbundling public services, in the sense that states could compete for club members outside their traditional territorial boundaries.

CONCLUSION

A remarkable quality of Hayek's writings on federalism is their optimism as to the feasibility of creating a more peaceful and prosperous international order. Written against the background of totalitarianism and war in Europe, they describe a possible future in which nation states band together to engage in close economic cooperation.

Paul Lewis has recently emphasized that, in the 1930s and 1940s, Hayek saw "the need to reframe liberalism as a positive doctrine" (Lewis 2020, p. 56). This means that Hayek wanted to make concrete suggestions on how to improve the institutional framework of markets. His 1939 paper and further remarks on the prospects of international federalism are an excellent example of an institutional proposal in the sense of Lewis' observation.

With this proposal, Hayek embraced the possibility of rationally choosing and implementing a particular institutional design. This approach stands in contrast to (some of) his later works, where he says that institutional changes should mainly be driven by evolutionary forces and that deliberate design runs the risk of engaging in "constructivist rationalism" (e.g., Hayek 1973).

The dismissal of rational institutional design in Hayek's later works was famously criticized by Buchanan, who argued that Hayek put too much trust in the beneficial working of evolutionary processes.¹³ However, as seen in this paper, Hayek's discussion of federalism was actually very close in spirit to Buchanan's future constitutional political economy project. Like Buchanan, Hayek points to efficiency shortfalls in the economic and political *status quo* and explains how adopting federalist government structures would address these shortfalls. In his federalism writings, Hayek seems to share Buchanan's convic-

tion that the practical task of the liberal economist is to construct “realistic utopia[s]” (Buchanan 2005, p. 98).

NOTES

- 1 In this paper, the term liberal will be used in the sense of classical liberalism or libertarianism (Mack and Gaus 2004), not social liberalism.
- 2 Another notable instance is Hayek’s “model constitution”, a bicameral legislature intended to ward off interest group influence (Hayek 1979, pp. 105-127).
- 3 Hayek prominently cites Robbins’ position on this matter in his 1939 paper: “There must be neither alliance nor complete unification; neither *Staatenbund* nor *Einheitsstaat* but *Bundesstaat*” (Robbins, cited in Hayek [1939] 1948, p. 270).
- 4 For example, Hayek described a Central European federation encompassing the countries of the former Austro-Hungarian Empire (Hayek 1945).
- 5 By and large, the participants at the meeting did not share Hayek’s and Robbins’ enthusiasm for the topic. See Hayek ([1947] 1992, pp. 244-245) and Caldwell (2020, p. 39).
- 6 On the legal terms *imperium* and *dominium*, see Schmitt ([1950] 2003, pp. 46-47).
- 7 On the Leviathan model, see Brennan and Kliemt (2019).
- 8 Similarly, in *The Road to Serfdom*, Hayek notes: “It is, in fact, one of the main advantages of federation that it can be so devised as to make most of the harmful planning difficult while leaving the way free for all desirable planning. ... [Federation] confines international planning to the fields where true agreement can be reached not only between the ‘interests’ immediately concerned, but among all those affected” (Hayek [1944] 2007, p. 233).
- 9 On the distinction between the concepts of federalism and decentralization, see Kantorowicz (2019, p. 75).
- 10 From a Hayekian perspective, this “voting by feet” mechanism not only makes the provision of public goods more efficient but also makes it possible to discover new approaches to public goods provision based on local knowledge (Vihanto 1992).
- 11 For a critique of the welfarist tradition in public finance, see Delmotte and Nientiedt (2022).
- 12 On the development of Buchanan’s thought on federalism, see Feld (2014).
- 13 See Buchanan ([1975] 2000). Apparently, Hayek never responded to Buchanan’s challenge (Levy and Peart 2020, p. 170).

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