Ludwig Lachmann as an Institutional Economist

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Extended Abstract

Ludwig Lachmann is known primarily for the radical subjectivism developed in his contributions on capital theory and the role of uncertainty in economic life. In this paper we explore the genesis of a lesser known area of Lachmann's work: the emergence and evolution of institutional frameworks and their role in constituting social orders. Special emphasis is put on the concept of "neutral institutions" – institutions which had emerged spontaneously at some point in the past to fulfil a specific function, but failed to vanish once the function they performed was not needed anymore, thereby giving rise to all sorts of social and institutional pathologies. An explicit link is made from Lachmann's outlook on the potential failure of social institutions to evolve in such a way as to fulfil the needs of the societies subjected to them to his rather pessimistic outlook on the prospects for effective coordination of supply and demand on markets. Vernon Smith's work on asset-bubbles and their avoidance in experimental settings and his more recent transfer of the market logic settings onto questions of institutional evolution of entire societies and the concept of "ecological rationality" is discussed as an analogy to the sequence of Lachmann's own thought, albeit with more pessimistic conclusions. Finally, the paper also briefly discusses Lachmann's institutional theory in light of current research in New Institutional economics, suggesting that Lachmann's work is underappreciated and potentially fruitful for the modern discourse in development economics, transition studies and contextual economics.

Section 1a of the paper provides an overview of Lachmann's conception of institutionalism and introduces to his taxonomy concerning the matter. While Lachmann distinguishes between "external" and "internal" institutions to lay out which institutions need to be present for market-like structures to ever arise (the former) and those which market interactions can bring forward themselves (the latter)[1], the category of "neutral" institutions takes prime importance here. Those refer to institutional structures that came into being at some point in the past with the

[1] As examples for external institutions Lachmann gives the legal system and police forces, as imporant internal institutions that have historically involved naturally from market settings he deems to be for instance insurance.

task and potential to overcome or ameliorate some social problem. Over time, this functional component of the institution has however been lost, while no effective mechanism existed to eliminate the institutional structure again.[2] We will pick up this line of analysis again in section 2b. Furthermore, section 1a also introduces to Lachmann's use of "shared facts", "reference framework" and "points of orientation" and lays out how it is that the forming and enacting of plans can be seen as his starting point for the dealing with institutional matters, which is based thoroughly subjectivist approach focusing on expectations and the interpretation of "facts" on the part of the actors.

Section 1b on the other hand contextualizes Lachmann's institutionalism and its historical genesis. The unique influence of a vast variety of traditions in economic thought and the broader social sciences (such as the German Historical School, Max Weber, Alfred Schütz and of course the Austrian School) are laid out here as decisive influences on Lachmann's institutional thought. Furthermore, this section introduces the relevant secondary literature on questions of Lachmann and institutionalism (such as Vaughn 1992; Foss and Garzarelli 2007; Lewis and Runde 2007; Storr 2019) and finishes with our own view on Lachmann's unique take on order, institutions and their evolution and why it might be particularly suited to expand our understanding in fields where the more mainstream conceptions have ran into a dead end. Among other things, we particularly stress the strength of Lachmann's approach to view processes of institutional evolution over time and on multiple levels of analysis.

Section 2 applies the Lachmannian framework presented in section 1 onto two concrete real-world examples. Section 2a highlights that Lachmann's theoretical framework allows for the discussion of both markets' potential for coordination as well as discoordination by hinting at the peculiar and delicate nature of asset markets. While coordination on regular markets (Lachmann frequently cites the market for "carrots" or "cauliflower" as perfect examples of these) is quite unambiguous vis a vis what the nature of the goods being traded is and what a potential buyer can expect by purchasing them, the situation is different on asset markets, Lachmann thought. On these, the story goes, expectations command a much bigger influence, because what is traded is not an actual good available for immediate consumption, but a variable income stream derived from an asset that is subject to all sorts of uncertainty. Given that, as Lachmann put it, "the future is unknowable, though not unimaginable", what drives these

[2] Lachmann thought that with respect to this especially the influence of cultural convictions on institutional action could become a great problem: the view that apparently no money wage should ever be allowed to fall could, in combination with strong union presence in a country, lead to persistent problems of inflation in a country.

markets is not a perceived difference in the value and the price of an asset, but a different assessment of it future potential to supply a revenue stream. Hence, those markets are prone – especially in times of market euphoria or its counterpart, depression – to periodic fluctuations during which it is next to impossible to establish any sort of reasonable tendency towards equilibration. At the very least, these processes might have a tendency to be severely delayed, because the initially widely diverging expectations of market participants need to be brought into accordance with each other.

Section 2b shifts the debate about the potential for permanent discoordination and its dire consequences on the social order to the macro- or institutional level. In a similar way in which individual markets for asset goods might not converge towards equilibrium, in the Lachmannian notion also the institutional and belief-systems of entire societies do not necessarily display tendencies at amelioration and the weeding out of institutional dysfunctionalities and errors. As has already been demonstrated, the concept of "neutral institutions" – previously functional institutions whose dismay is hindered by the existing social norms and cultural convictions – takes prime importance here. What is fundamental for our account here is to carve out and recognize the continuity between Lachmann's view on potentially never-ending disequilibrium in asset markets and the realization that also entire societies can remain, for a long time and potentially forever, in institutional traps and sclerosis. The section also demonstrates how Lachmann’s institutionalism evolves from his days at LSE, where he is importantly influenced by his engagement with F. A. Hayek and G. L. S. Shackle, to his later years, when his research on Max Weber re-connects him to his intellectual roots in the German Historical School. We suggest Lachmann’s intellectual journey provides valuable insights for contemporary scholars of institutions.

Section 3 links Lachmann's theories to the more modern and empirically underlined approach of Vernon Smith. We demonstrate how the main preoccupations of Smith's work closely coincide with the one of Lachmann and how even the conclusions to be drawn from their approaches are largely complimentary. What corresponds to Lachmann's endeavor at explaining institutional pathologies on the societal level is Smith's idea of ecological rationality, with the help of which the simple notion of rationality is extruded from its familiar context on the individual level and is instead shifted over to be treated as a systemic phenomenon: what is rational is not to be determined by deductive reasoning and can never be valid for all actors. This notion is surprisingly close to Lachmann's own writing on how the overall institutional order creates its particular "situational logic" which may severely influence the participants' interpretation of what rationality is. On the individual level, Smith's work obviously offers a vast amount of experimental insights onto the operation of real-world markets, which largely seems to suggest the Lachmannian vision of markets holding both, the potential for coordination as well as for discoordination. We argue that Lachmann's predictions on the matter, albeit somewhat too pessimistic, are in a way vindicated by experimental evidence; at least in the sense that markets for asset goods follow divergent patters of markets for "ordinary" goods. We propose that there exist vast congruities between the work of Lachmann and Smith that have been completely ignored before. In the same sense as Lachmann's characterization of markets being prone to produce failures on the micro-level has a corresponding expression on the societal/institutional level, Smith's dabbling onto what makes individual markets work can be linked to his later endeavors about "ecological rationality" and the institutional features influencing the market processes unfolding in various societies. The section also briefly discusses the applicability of Lachmann's approach to institutional analysis in light of recent developments in the field of New Institutional Economics. It is argued that Lachmann could be of great use for the field for two reasons: firstly, the explicit lookout for institutional failures helps to shift analysis from the all too common focus on institutional reform to a more *verstehender* approach that will be in a better position to explain why it is that certain societies end up with the (potentially sclerotic) institutions that they display. Secondly, Lachmann is useful for – as we have shown – having explicitly connected his theory of the market with his approach to institutions – a feat that we deem to uncommon in institutional analysis these days.

Methodically, the paper makes use, apart from textual analysis, of Lachmann's private library located at Archiv des Liberalismus in Gummersbach, Germany. By also incorporating non-textual sources, the paper aims to better draw out the genesis of Lachmann's thought and illustrate the process by which seemingly heterogeneous traditions of economic thought merge in Lachmann, giving him his unique outlook on the role institutions play in ordering economic life.

Section 4 concludes and highlights potentially fruitful avenues for future research.

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Structure:

1. **An overview of Lachmann's conception of institutionalism**
    a. **Taxonomy** (~3 pages)
        i. Explain "external", "internal", and "neutral" institutions, his use of "shared facts", "reference framework", "points of orientation", and his expansion of subjectivist analysis to expectations and interpretation.

ii. Compare and contrast Lachmann's taxonomy with that of the neoinstitutionalists and Hayek (Lachmann's Shackle inspired view of choice might also fit into this section).

b. **Contextualize Lachmann's institutionalism and discuss the "Lachmann problem"** (~5 pages)

i. Point out the unique influence the German Historical School, Max Weber, and Alfred Schutz may have had on Lachmann's conception of institutions.

ii. Reference the (Vaughn 1992; Foss and Garzarelli 2007; Lewis and Runde 2007; Storr 2019) papers that have already tried to unpack Lachmann's peculiar take on order.

iii. Finish off the section with a segue that includes our own view of Lachmann's unique take on order and institutions (which highlights processes over time and at different levels) and how we believe it may be particularly suited to expand our understanding in fields where the more mainstream conceptions have ran into a dead end.

2. **Applying Lachmannian insights in institutional analysis**

a. **Market bubbles** (~3 pages)

i. Lachmann's theoretical framework allows for the discussion of both markets' potential for coordination as well as discoordination

b. **Institutional pathologies** (~2 pages)

i. Explore whether Lachmannian institutionalism, with its more careful integration of the time/process factor, can say something more about institutional change than already established approaches. Build on the asynchronous development of institutions angle, how subjectivism of interpretations is relevant for "stickiness" etc.

3. **(Lachmann-Smith connection) Order as an ecological/systemic phenomenon** (~6 pages)

a. **Ecological rationality, systems thinking (situated+internal cognition etc.)**

i. Build on (Dekker and Remic 2018), "situational logics", potentially tie in Alchian

b. **Experimental work**

i. Markets' potential for coordination as well as discoordination (assumed by Lachmann) shown in the lab

4. **Conclusion** (~1 page)