The Legacy of Lachmann’s Theory of Institutions

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Abstract:
The goal of this paper is to suggest a modification in the theory of institutions put forth by Lachmann in the second chapter of “The Legacy of Max Weber”. The original theory affirms that the institutional matrix of a society evolves in a manner similar to the capital structure, where the sum of the parts forms a complex order that evolves over time. We will restate his theory in such a way as to explicitly incorporate the notion of path dependence, established by Douglass North, as well as the concept of polycentricity, defended by Elinor Ostrom. Then, we will show that this theory contributes to the standard neoinstitutional economics because it is able to explain the evolution of a complex institutional matrix that provides coordination among individuals who act in a world of radical uncertainty. Moreover, this paper will provide a sketch of an empirical research agenda based on a modified version of Lachmann’s institutional theory. Such an agenda would be focused on historical studies related to the emergence of institution within a given matrix, as well as on process of institutional reforms. Therefore, empirical researches based on a lachmannian institutional theory could contribute to the literature that deals with local solutions to institutional problems, made well known by Elinor Ostrom. In addition, they would be able to enrich the economics of transition, shedding light on the shock therapy versus gradualism dilemma. Hence, a more modern version of the theory of institutions put forth by Lachmann which incorporates recent concepts as path dependence and polycentricity could contribute positively to the institutional economics. It would provide a theoretical framework that emphasizes the complexity of an institutional matrix that is ever evolving, which in turn could be applied to the analysis of historical cases related to endogenous rule formation.

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Introduction

Many contemporary authors affiliated with the Austrian School of Economics have made contributions with respect to theories of social institutions (Boettke, 1989; Langlois and Hodgson, 1992). Throughout its history, such a school has contributed significantly to the institutional economics. Menger (1892), the founder of this tradition, suggested a theory on the origins of money, while Hayek later on made a general theory of cultural evolution based on group selection. Lachmann (1971), in turn, argued that the institutional structures function, in many respects, similarly to capital structures.

Notwithstanding the progress made in the literature of theory of institutions, in general, (North, 1990) and in the Austrian theory of social institutions, in particular, (Langlois and Hodgson, 1992), Lachmann’s theory of institutions, presented in second chapter of The Legacy of Max Weber (1971), has not yet been included in a modern general theoretical framework of institutional economics.

In fact, one will rarely find Lachmann’s name in papers that intend to make progress on the literature of theories of institutions (Langlois and Hodgson, 1992; Ostrom, 1991; North 1990)\textsuperscript{3}. Even Austrian economists usually prefer to work upon the contributions set forth by Hayek, instead of developing Lachmann’s theory, as we can see, for instance, in Langlois and Hodgson (1992)\textsuperscript{4}.

However, we will argue in this paper that Lachmann’s theory can be improved in a manner to contribute effectively to this literature. If his theory explicitly incorporate the language of evolutionary epistemology, we will suggest, the lachmannian theory of institutions could express concepts such as polycentricity, put forth by Ostrom, and path dependence, made well known by North.

The evolutionary epistemology presents a meta-theory of evolutionary processes, comparing their functioning in different fields. Bartley (1990), for instance, compares the evolution of knowledge in science and in markets. Campbell (1960), in turn, affirms, “A blind-variation- and-selective retention process is fundamental to all inductive achievements, to all genuine increases in knowledge, to all increases in fit of system to environment (p.91)”.

\textsuperscript{3} Of course, there are exceptions. See, for example, Foss and Garzarelli (2007).
\textsuperscript{4} Lachmann is cited in this article, but the focus of it is to develop the hayekian (and to some extent, mengerian) theory of institutions.
When applied to the institutional theory established by Lachmann, evolutionary epistemology language allows us to understand the conditions under which the path of an institutional matrix tend to produce the conditions that result into economic stagnation or prosperity.

Besides contributing to the pure theory of institutions, the Lachmann’s framework could be applied to analysis of historical cases. In fact, the complementarity among institutions emphasized by Lachmann could be illustrated in cases of institutional transitions, shedding light on the shock therapy versus gradualism debate.

In addition, Lachmann’s theory could enrich the literature that studies local solution to institutional problems advanced by the Virginia and Bloomington School of Economics. This literature produced by these two school show how individuals in a decentralized world coordinate their plans in order to provide solutions to collective actions problems, such as the tragedy of the commons. Hence, a framework that emphasizes the heterogeneous structure of an institutional matrix could shed more light on the local formation of rules in a polycentric order.

In order to present these arguments, we organize this paper in the following way. First, we will discuss the theory of institutions found in the work of Menger, Hayek and Lachmann. In the second section, we will discuss the evolutionary epistemology and its possible application to the Lachmann’s theory. Then, we will show how this reconstruction of the Lachmann theory would be general enough to incorporate the concepts of policentricity and path dependence. Next, empirical applications of this theory are discussed. The final section concludes.

Theory of Institutions in the Austrian School

In order to argue that the Austrian tradition exhibits a rich tradition of institutional analysis, we begin with a brief exposition of Austrian institutional ideas, from Menger to Lachmann.

Works dealing with institutions can be found already in the texts of Carl Menger, the founder of the Austrian School. As it is well known, Menger developed the theory of marginal utility and tried to popularize his economic theory among the German speaking community. He, however, faced opposition of Schmoller, the greatest economist of the
German Historical School at the time, in a conflict known as “The Battle of Methods” or “Methodenstreit” (Bostaph, 1994).

Schmoller argued that a universal economic theory is impossible in face of the multitude of particularities of time and place. A theory that is valid for Great Britain, for instance, would not work for Germany. Believing otherwise would be an example of “Manchesterism”\(^5\). The researcher would have to extract economic theory from historical analysis. In fact, he argued that theory and history were the same thing.

In addition, political economy could not be isolated from sociological considerations. The researcher would have to take into account the spirit of the people (Volksgeist) he analyses, as well as others institutional features. Pure theoretical economics, therefore, could not say anything about the real world.

Menger (1996 [1883]), on the other hand, separated pure theory from history. He claimed that the economist should identify very general or abstract “exact laws” that, in turn, would guide statistical or historical studies. In addition, Menger used pure economic theory to explain the origins of money, an important institution, money, contradicting Schmoller’s claim about the barrenness of pure theory.

The Austrian author argued that there were two types of institutions: organic and pragmatic. A pragmatic institution is a deliberated product of an authority or commission. It refers to specific regulations or construction with a clear aim. Organic institutions, on the other hand, are the unintended result of the combination of the plans of various actors. The language is the most clear-cut example of an organic institution. No one created it single handedly: it is the product of human interaction over centuries, and it is always evolving.

According to Menger (1892), money is an example of an organic institution too. In a barter society, goods with more liquidity can be used as intermediates in trade. As the individuals succeed in trade using certain intermediate good, their behavior are copied by others. Hence, the liquidity of this good is increased. The price of this good, as time passes, starts to express its use as a mean of exchange, instead of its original function. Therefore, this particular commodity becomes money.

\(^5\) In reference to the authors of the Manchester School. See Bresiger (1997).
Menger’s theory on the origin of money makes use of economic reasoning to explain the pattern of evolution of a particular institution. It does not ignore the role of history or government design. However, the theory explains endogenously the origin of an institution that is usually taken as given. As an heir of the Scottish enlightenment, Menger expands the study of the unintended consequences of human action using economic theory.

Hayek is the next author of the Austrian tradition to study the emergence of institutions. His whole institutional theory is based on the knowledge problem he formulates on the article “Use of Knowledge in Society”:

“The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken to mean given to a single mind which deliberately solves the problem set by these "data." It is rather 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”. (Hayek, 1945, p.51).

For him, the spontaneous order of the society, in general, and of the market, in particular, is generated within an institutional framework. Thus, the tendency to equilibrium of the market process is institutionally contingent. Under a system of private property an evolutionary process emerges which coordinates actions in markets. However, Hayek believed that the nature of the process of evolution of the institutional framework was different from the evolutionary processes within the institutional framework. The economist, therefore, should use different tools to analyze these processes (Oliva, 2016, p.35).

While prices in a market system provide signals that coordinate individual plans in the face of change, such mechanisms would be absent to guide changes in the institutional structure of society. Other factors would account for institutional evolution. Thus, Hayek argued that institutions would evolve in a process of cultural evolution
produced by group selection: successful groups survives and their rules are imitated by others.

According to Hayek, human are as rational choosers as they are rule following animals (1973, p.11). Since we are children, we learn rules of behavior. Some of them are explicit, while other rules we cannot even formulate in words. These cultural rules structure the interactions among individuals. Therefore, they shape the pattern of the social order.

All social institutions are culturally embedded: they are not the creation of single minds. They may shape the social world even if individuals dislike then. The social world functions because individuals are able to follow social rules, not because they are particularly smart.

Different rules of behavior, however, do not result in the same social outcome. Some rules result in social orders more adapted to the environment than other sets of rules. Thus, the process of group selection accounts for the elimination of unfit cultural rules of conduct.

In addition, this process of cultural evolution produced rules that are apparently contradictory. While some rules are appropriate for life in family, we follow other rules when in touch with strangers in an extended society. Thus, the modern man is required to constantly live in two worlds and to change his behavior accordingly. This conflict, says Hayek (1989), is behind the modern claim for socialism and its accusation of alienation in the modern world. Collectivist impulses are viewed as a dysfunctional evolitional heritage from a tribal past.

Lachmann, who studied with Hayek, inherited from him an awareness of the importance of the problem of the coordination of the actions of individuals with dispersed knowledge. From Menger, he borrows the notion that, while some institutions are constructed single handedly, some of the most important of them emerge spontaneously.

The mail tool used in Lachmann’s theory of institutions, however, comes from his work on capital theory (Lachmann, 1956). This theory is based on the notion that capital goods are heterogeneous in use and that they have the property of multiple specificity. When combined, capital goods would form a structure, the parts of which would have the relation of complementarity and substitutability among each other. The price system
would provide the incentives to maintain a certain order and coherence in the structure. Gaps in it would generate profit opportunities, while losses would incentive a rearrangement of the capital goods.

For Lachmann, the institutional structure is heterogeneous as well. The web of interlinked institutions provides points of orientation to the actions of the individuals. The external institutions, such as the legal order, would provide the basic framework under which internal institutions, of organic nature, would emerge in an evolutionary fashion.

As time passes, the institutional structure would have to adapt to changes. The process of adaptation, however, would not be spontaneous as in the case of the capital structure. The legal order, for instance, cannot remain fixed in time, but it cannot change abruptly either, in order to perform its function of orientation. Legislators, therefore, face the tradeoff between flexibility and permanence with respect to institutional change. With respect to other institutions, however, permanence is a feature that is not so required, opening more room for experimentation.

Because there is no mechanism of coordination analogue to the price system, the institutional structure as whole is not as coherent as the capital structure. However, some parts of the institutional structure have a great degree of coherence. A judge, for instance, should always find a solution based in the law to the cases he is presented. The legal order, therefore, is a closed system that should not have any gaps.

In this section, we presented the institutional theory of three Austrian economists, Menger, Hayek and Lachmann, showing the emergence of a coherent research program which deserves to be studied and developed. In the next section, we will present the basic features of the evolutionary epistemology and argue that it could be used to improve Austrian institutionalism.

**Lachmann and Evolutionary Epistemology**

Authors of the evolutionary epistemology tradition discuss patterns of growth of knowledge within different institutional environments, where knowledge is defined as any construct that provides adaptation (Campbell, 1987). Karl Popper, for instance, argues that scientific knowledge is more likely to grow when conjectures scientists make are open to criticism and discussed objectively, independently of whom formulates them.
In addition, Popper advocated academic freedom as a mean to overcome fallible knowledge. Free competition of ideas would provide selective pressure to eliminate wrong theories, whereas dogmatism would refrain the refutation of possibly mistaken propositions.

Friedrich Hayek, in the same spirit, argued that competition in markets under an institutional setting that enforces private property provides the discovery of local knowledge, which in turn is conveyed via price system. Hence, Hayek analyzed the growth of “commercial” knowledge, while Popper studied the growth of scientific knowledge. Referring to this similarity between both processes of growth of knowledge, Bartley (1990) stated that philosophy of science is a branch of economics (p.89).

The tradition of evolutionary epistemology, however, is not limited to the social sciences. Campbell (1960), for example, argues that biological evolutilonal is a process of knowledge growth. In addition, the very process that generates vision could be interpreted as an evolutionary one (Reddy, p. 36, 2011). The functioning of the eye would be analogous to a radar: this organ would provide a map of the environment via “selection” of the solar beams reflected in it. The difference is that the eye utilizes more “waves” (interpreted as “trials”) than the radar, in addition to the fact that it possesses a more sophisticated “selection” process.

In general terms, any evolutionary process is defined in terms of three basic components: 1) blind variation; 2) selection and 3) heredity.

Blind variations refers to a variation in any device that is related to the adaptation of the organism (or idea, or device) in question. It is blind because the variation is not instructed in the direction of an optimal solution, because this optimal solution is not known beforehand. In the words of Campbell, “uncorrelated with the solution, in that specific correct trials are no more likely to occur at anyone point in a series of trials than another, nor than specific incorrect trials (p.91)” Selection, in turn, consists in the elimination of unfit organism or devices. The criteria of selection may be impersonal (like in the case of natural selection) or subjective (like in science, where the scientist chooses if he accept or not a criticism). In the latter case, Campbell says that humans exert the function of “vicarious selectors”. Heredity is the retention of successful variations via transmission, for example, of the relevant features to the offspring. In other words, the selection process needs to be retentive. In case of competition of markets or in science,
successful plans or ideas are copied by other individuals and thus do not disappear as unfit plans or ideas do.

Let’s exam now how institutional analysis should benefit by the use of an evolutionary framework. Hayek is an author who studied institutions using an evolutionary approach, as we have already pointed out. However, Hayek states his theory in a too general a manner. He claims that, because different rules yield different social outcomes, some institutions would be less fit than others. How the evolutionary process of evolutions is affected by changes in parameters, such as rate of variations, stability of environment or differences in the nature of selectors is not discussed.

In addition to detailing the theory in terms of the basic parameters of an evolutionary model, Hayek's theory of cultural evolution must incorporate contemporary discussions about evolutionary psychology, especially in a review of what can be explained by cultural factors or by constraints imposed by human nature itself.

The relations among the institutions in a structure are not mentioned either. Lachmann’s development of the theory, therefore, makes possible to consider institutional rigidities, making clear the difference between external institutions, which tend to be more difficult to change, and internal institutions, which change more easily. Evolutionary epistemology, thus, allow us to analyze how changes in parameters, e.g., environment stability, number of mutations, shape and number of recombination, the degree of vicariousness of the process, affect the pattern of the process of institutional evolution.

Thus, the idea of this paper is to combine the ideas of Lachmann and evolutionary epistemology as a basis to make pattern prediction about institutional evolution. In particular, the parameters we will analyze will be the type of institutional variation and the criteria of selective retention.

As an instance of this kind of analysis, we can argue that institutional structures will be more apt to cope with community problems and therefore more conducive with economic growth when polycentrism\(^6\) and self-governance are strengthened. That is the case because decentralization allow the use of different mental models, each one functioning as a vicar selector that greatly reduces the costs of the trials in learning.

\(^6\) Ostrom (2010).
processes. In addition, polycentrism creates competition among communities, thus making the criteria of retentive selection more decentralized and hence more compatible with the citizens’ preferences.

On the other hand, excessive centralization reduces variation and makes selection less effective, because trials are evaluated only by the criteria that could be devised by the central authority. Thus, inferior institution tend to remain, as the process of error elimination is refrained. This phenomenon, in turn, corresponds to the path dependence of institutional evolution pointed by North, which can produce economic stagnation in a country in the long run.

Therefore, the analysis of the evolution of an institutional structure, presented by Lachmann, can be enriched when combined to the evolutionary epistemology literature. This literature discusses the patterns of evolution of different kinds of knowledge. When specifically applied to the Lachmann’s development of Austrian theory of institutions, evolutionary epistemology puts the problem of how to develop a complex institutional structure able to cope with a plethora of problems of social organization.

Similar problems have already been discussed in the debate of economic calculation under socialism. Mises (1971) mentioned the enormous “division of intellectual labor” required to coordinate the capital structure in an industrial society. Thus, he argued that only with private property of the means of production, and thus with free market, would a society be able to overcome the complexity of the economic problem. In other words, without private property, there would be no rational economic calculation, because no authority would be capable of grasping the knowledge required to adjust the capital structure to the production of the goods most urgent needed. In a similar fashion, Hayek (1940) pointed out the astonishing complexity of the allocation problem in a modern society and dismissed the idea that a central planner would be able to solve it guided by equations of the walrasian general equilibrium apparatus.

Hence, both the building of a capital and an institutional structure require an enormous amount of knowledge. In the present paper, we will use the evolutionary epistemology to try to answer how this knowledge problem can be overcome in the case of institutional change.

Next, we will restate the Lachmann’s Theory of Institutions using the evolutionary epistemology language and show how it might contribute to the institutional literature.
Lachmann’s Institutional Theory Restated

The building of an institutional structure requires a great amount of knowledge of local conditions in order to succeed. The parts of the structure, which are complementary among each other, guides the plans of a great number of individuals who act in a world of uncertainty. Institutions, thus, also economize information. For Lachmann, institutions are “nodal points of society, co-ordinating the actions of millions whom they relieve of the need to acquire and digest detailed knowledge about others and form detailed expectations about their future action” (Lachmann, 1971, p.50)

Let’s see an outline of the problems posed by an institutional structure. To perform the function of points of orientation to the individuals, the structure should adapt to changes that happens throughout time, while maintaining some stability. Hence, there is a tradeoff between flexibility and stability in the evolution of an institutional structure. In the words of Lachmann:

“If institutions are to serve us as firm points of orientation their position in the social firmament must be fixed. Signposts must not be shifted. On the other hand, it is hardly possible to imagine that banks, railways, and other institutions are totally exempt from change. It appears that such change need not interfere with the plans of users of institutions provided it is known in advance. But some changes will not comply with this condition. What happens then?” (p.52)

The building of the matrix of institutions should also ideally fill the gaps among the institutions that comprise the whole structure. That is, the interstices in the various points of orientations should be repaired in the process of efficient institutional change. However, “what is the general nature of the conditions in which such new institutions would 'fit' into the existing structure?” (p.52)

In addition, there are different paces at which each part can change. There can be no two different constitutions at the same time in the same country, yet it is possible to exist variations in other types of rules. “The legal order can absorb some changes, but not too many of them, and they must not be of a fundamental kind” (p.72). The institutions of the first kind are said to be “external”, while the latter is “internal”. “External institutions provide the “outer framework of society, the legal order,” which allow internal institutions to evolve “as a result of market process and other forms of
In which ways can these challenges be dealt with? What is the best one? Using the language of evolutionary epistemology, we can propose an outline of an answer to these problems.

Institutional change occurs in a more or less centralized fashion. When an agency of the federal government establishes the rules that will govern the allocation of a certain good considered public, for instance, institutional change is centralized. On the other hand, when those rules emerge from actors interacting locally, institutional change is said to be decentralized.

In the latter case, individuals will build institutions to govern their society based on local knowledge. The presence of local and different selectors allow the use of more variations and more criteria that inform each selective mechanism. This allow the emergence of novelty. In addition, the prior stock of knowledge will tend to reduce the numbers of attempts required to construct desirable institutions, in comparison with a centralized process of variations relatively uninformed by past processes. The use of knowledge of local conditions, mentioned by Hayek (1945), will therefore produce a better pattern of institutional structure.

The centralization of selectors of institutions is also likely to produce the phenomenon Douglass North (1990) called “path dependence” leading to stagnation. Inefficient institutions in centralized environment tend to remain, because the selectors will not able to eliminate or correct then. On contrary, they will reflect, for instance, the preferences of rent seekers who benefit from then.

The competition between localities also create incentives to discover and design efficient institutions (Kerber and Vanberg, 1995). Those incentives, however, are absent if the building of institutions is monopolized by a single agency.

Therefore, the freedom of association among individuals yields a pattern of institutional design that embodies a bigger amount of knowledge than the results from centralized constructing. The use of this knowledge allows the construction of complex institutional structures, analogous to complex capital structures, containing many complementary parts.
The decentralization of institutional evolution also makes room for entrepreneurs that want to seize the opportunity to fill the gaps in the institutional structure while profiting with that. Hence, entrepreneurial activity continually improves the institutional structure, in the same way that happens in the capital structure under the framework of free markets.

Thus, in the language of E. Ostrom (2010), an environment of polycentricity, defined as “multiple centers that are formally independent from each other” (p.3) is likely to deal in a better way with problems of social cooperation than a centralized one. In fact, her entire work illustrates the power of free association to solve all kinds of social problems.

The use of evolutionary reasoning allows us to claim that solutions to the problems Lachmann posed regarding the institutional structures, e.g., the tradeoff between flexibility and stability, involves the adoption of decentralization. The knowledge generated by the local interaction of a plethora of agents makes possible an efficient building of a complex institutional matrix.

In summary, the reformulation of Lachmann’s theory of institutions leads to the conclusion that a rule framework that guarantees freedom to build institutions in decentralized fashion will tend to produce institutional structures more fit to govern life in society than a framework that centralizes this task.

Similar conclusions were reached by authors of evolutionary epistemology tradition working in different fields. Popper (1963) and Polanyi (1951) argued that academic freedom is more prone to advance science than central control of academy. Hayek defended economic freedom as means to support life in complex industrial societies. Therefore, it is not surprising that the application of evolutionary reasoning led to conclusions compatible with the classical liberal tradition. Freedom is a necessary condition to build complex structures in all fields, be it science, markets or institutions. This is so because fallible knowledge and complex coordination problems require a learning mechanism by trial and error and the first element requires freedom. As Hayek (1960) put succinctly, “the case for individual freedom rests chiefly on the recognition of the inevitable ignorance of all of us concerning a great many of the factors on which the achievement of our ends and welfare depends” (p.80).
Besides leading to the conclusion that decentralization generally leads to efficient results, the combination of Lachmann’s institutional theory and evolutionary epistemology allows us to study paths of institutional evolution in some detail. While Hayek’s theory is very general, stating that somehow the rules of some groups will be selected in detriment of others, Lachmann’s theory restated allows us to analyze how changes in some parameters affect different parts of the institutional structure.

Hayek’s group selection theory makes sense when small tribes compete with each other. When societies grow, there is no such a thing as group selection. A country may continually adopt bad policies and implement inefficient institutions without being completely disrupted. The process of evolution changes throughout time. Group selection could be important in Pleistocene, but it is hardly a strong force nowadays.

Lachmann’s theory restated, on the other hand, makes possible to analyze changes in some parameters of the process of evolution. When individuals organize themselves in small tribes, there is a great deal of variation and the criteria of selection is decentralized. Thus, the evolution process tends to generate institutional that are more adapted. However, when political centralization emerges, variation decreases and the criteria of selection tend to reflect the preference of interest groups, so inefficient institutions tend to “survive” the process of evolution.

In this section, we restated Lachmann’s contribution to Austrian theory of institutions using the language of evolutionary epistemology. Doing that, we were able to make the theory general enough to incorporate the concepts of polycentricity and path dependence. In addition, we claimed that it could possibly improve Hayek’s theory of cultural evolution. In the next section, we will show that this restatement of Lachmann’s ideas allow us to possibly suggest new paths to empirical studies.

A Sketch of an Empirical Agenda

This restatement of Lachmann’s theory of institutions is able to produce pattern prediction regarding institutional change. When the external institutions allow for decentralization, the institutional evolution will tend to improve efficiency. On the other hand, when they impose centralization, evolution will lock societies in inferior results.
That basic insight can be used to guide empirical studies concerned with endogenous rules formation, or institutional building. This is the case when the researcher is interested in the analysis of economies in transition, in the governance of common goods, in studying societies in the aftermath of natural disasters or in a case of an institutional revolution.

Those studies, of course, are already made using similar theoretical references. Peter Boettke (2002) analyzed the end of the Soviet Union making use of public choice and austrian economics. Coase and Wang (2012) analyses the bottom up emergence of capitalism in China. Storr, Haeffelle-Balch and Grube (2015) emphasized the role of the entrepreneur in the recovery of Sandy and Katrina hurricanes. Mcginnis (1999) presents many empirical cases of polycentric governance of public and common goods. Another work that is worth mentioning is Leeson (2009), which claims that self-governance is able to build and enforce the rules necessary to govern social life. Raico (1994), in turn, argued that political decentralization was a crucial factor in the emergence of the “European miracle” that resulted in the rise of western industrial revolution.

Boettke and Candela (2016) even use Lachmann insights explicitly in their interpretation of McCloskey’s work on the Bourgeois Era. They say that an environment of institutional competition served as an “external institutional” within which the “internal institutions” of bourgeois virtues and ideas developed. Together, those institutions created the environment that triggered the emergency of the “great enrichment” (McCloskey, 2006, 2009, 2010).

Lachmann’s institutional theory restated can improve the theoretical understanding of the issues those cases present. It emphasizes the complexity of the task of institutional reform and points the tradeoffs involved in it.

Economies in transition which allowed genuine decentralization would succeed more than the ones that are centralized, according to this theory. A researcher could use this hypothesis to argue that the respect for de facto property rights in post Mao China (Coase and Wang, 2012) allowed it to succeed in the transition to a market economy more than Soviet Russia, which tried to impose Perestroika in a top-down fashion, with no respect for the existent property rights (Boettke, 2009). In the Post Mao China, Coase and Wang, p.156 claim:
Villages of starving peasants restored private farming and township and village enterprises outperformed state enterprises. In Chinese cities the introduction of self-employment and private entrepreneurship brought more vitality to the urban economy than did state-led enterprise reforms. The story of Chinese economic reform is one of obdurate private entrepreneurship, of bold but piecemeal social experiments, and of humility and perseverance in the human struggle for a better life.” (Coase and Wang, 2012)

On Soviet Union, on the other hand, “Perestroika failed in large part because it was not tried. Gorbachev between 1985 and 1991 announced at least ten radical plans for economic restructuring, not a single one was ever implemented” (Boettke, 1993, p.2)

Besides that, the complexity of the task of institutional building pointed out by Lachmann challenges the mainstream conception that institutions can be successfully implanted in a top down manner by a foreign agency, such as the World Bank. On contrary, institutions built locally tend to “stick” and adapt better to the particular features of the society (Boettke, Coyne and Leeson, 2008). The use of the local knowledge enables the agents to deal better with the tradeoffs associated with institutional building, such as the one between flexibility and permanence, as well as crafting the rules in a compatible way with the rest of institutional structure. Decentralization, therefore, allows the society to learn to deal in a better way with the shock therapy versus gradualism dilemma regarding institutional transitions (Popov, 2000; Violante and Barbieri, 2015).

This same principle applies to the study of communities recovering from natural disasters. Which path of institutional building is more fit to cope with the problems those societies face? Lachmann’s theory restated, in this case, predict that decentralized building is more likely to produce rules and practices which embodies the knowledge required to deal with then. While the control of centralized agencies results in undesirable path dependences, freedom of association and respect for property rights yields quicker recovery and may even prevent future destruction resulting from natural disasters.

Lachmann’s theory could also be useful to guide empirical studies made in Bloomington School fashion. In fact, E. Ostrom, for instance, combined empirical observations with theoretical considerations, such as game theory. Lachmann’s theory could shed more light in the polycentrism phenomena, highlighting the complex problems and tradeoffs regarding institutional building that only genuine decentralization can overcome.
In summary, Lachmann’s theory restated enables the researcher to produce comparative history of different paths of institutional building. This style of economic history is compatible with the features of mainline economics (Boettke, 2012). The economists of this tradition, such as Adam Smith, Mises, Hayek, Buchanan or Tullock, analyze the unintended outcome of human interaction under different institutional frameworks. Keeping the hypothesis of human nature constant, they evaluate how different rules produce different social results.

Adam Smith, for instance, using the hypothesis of self-interest, studied the outcome of human interaction under mercantilism and the “system of natural liberty”, defending the latter. Hayek, in turn, presupposing human ignorance, defended that a system of private property of means of production is more likely than socialism to overcome this limitation of knowledge, therefore enabling individuals to achieve their ends.

Lachmann’s theory, in the way here presented, makes pattern prediction of institutional building under different environments. Using the hypothesis of human ignorance, in the same fashion as Hayek, it claims that decentralization tends to yield better results. This theoretical conjecture, in turn, can be used to guide historical comparatives studies.

Conclusion

In this paper, we suggested a restatement of Lachmann’s contribution to Austrian theory of institutions. We argued that, when combined with the tools of evolutionary epistemology, it is able to produce pattern prediction of different paths of institutional building. In particular, we concluded that when variation is allowed, the institutional path of evolution would tend to incorporate the knowledge required to adapt to the environment, which continually changes. In the parlance of Ostrom and North, when polycentricity is strengthened, the institutional structure is able to adapt to changes, avoiding the trap of path dependence leading to stagnation.

The combination of Lachmann’s ideas on institutions with evolutionary epistemology makes possible to work on the legacy of Hayek’s theory of institutions. While Hayek’s evolutionary theory of institutions is put in a too general a manner,
Lachmann’s theory restated can incorporate several parameters and rigidities in the institutional structure. The legacy of Lachmann’s institutional theory, therefore, can be seen as the part of the broader legacy of Friedrich Hayek’s work.

In addition, we argued that Lachmann’s theory, when reformulated in our terms, is able to guide interesting historical studies, being capable to explain a plethora of stylized facts. In particular, because it has to property to yield pattern prediction of different cases of institutional emergency, the theory we proposed is particular useful to guide studies of comparative history, in the fashion of the mainline economics.

For a long time, Lachmann was considered a nihilist author, unable to produce useful theories to substitute for those he attacked. However, as we have shown here, the legacy of Lachmann is a progressive research program, which is still very fertile in new propositions. Reading Lachmann, therefore, is not only a matter of knowing the work of an old-fashioned economist, but also a way to learn new ways to advance economic theory.

In an age when economists are suspicious of the usefulness of economic theories that ignore the role of institutions and imperfect knowledge, the legacy of Lachmann’s work, in general, and of his institutional theory, in particular, provide an interesting alternative of progressive research program to work in. We hope to have shown in this paper that this in fact the case.

References


