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8

HIERARCHICAL METAPHORS IN AUSTRIAN INSTITUTIONALISM

A friendly subjectivist caveat

Steven Horwitz

Thanks in large part to the later work of Hayek and the varied contributions of Ludwig Lachmann, the post-revival generation of Austrian economists is rediscovering the importance of a theory of economic and social institutions for a healthy understanding of economic and social order. One can legitimately say 'rediscovering' because an emphasis on institutions was at the heart of Carl Menger's work that founded a distinct Austrian approach.[1] While Hayek's work on the evolution of institutions (e.g., Hayek 1988) put the notion of spontaneous order back at the centre of Austrian economics, Lachmann's enduring contribution can be seen as reminding us of the equal importance of seeing institutions in terms of the *meaning* that they have for actors. Lachmann's work on institutions can thus be seen as an attempt to extend subjectivism beyond tastes, knowledge and expectations to our understanding of the very institutions that help to co-ordinate our diverse subjectivities.

What I hope to accomplish in this chaprer is to search for any unacceptable lingering objectivism in the treatment of institutions by both Lachmann and other post-revival Austrians. My point is not merely to be deconstructive (although that is important), rather I want to give the discussion of institutions a nudge towards being more completely subjectivist, and thus more true to Lachmann's own conception of economic theory and social order.[2] More specifically, there is a sense in Austrian discussions of institutions that there is a certain 'hierarchy' of institutions, or that, in Lachmann's (1971: 81) words, there are 'internal' and 'external' institutions. My argument is that this way of talking about institutions can easily lead us to posit incorrectly an objective structure or ordering of institutions that exists separately from either the particular questions posed by theorists, or the subjective perspectives of actors in those institutions. The argument will be fleshed out by borrowing some concepts from the Austrian theory of capital to sketch a different conceptual framework for discussing institutions, and by an illustration from the history of banking.

Austrian institutionalism

The focus of my critical attention will be the work on economic and social institutions by both Lachmann (1971, 1986) and Richard Langlois (1986a, b, c, 1992). The reason for this narrow focus is that these two authors have developed the most 'Austrian' treatments of institutions.[3] It is also in their work that notions of 'externality/internality' and hierarchy come to the fore. It should be noted that none of my critical comments should be seen as directed towards the general idea of an Austrian institutionalism. To the contrary, the analysis of the origin, evolution, and function of institutions is one of the most powerful contributions Austrians can provide and the hope is that a more thorough subjectivism can improve work along these lines.[4]

Lachmann's theory of institutions is most clearly sketched out in his book *The Legacy of Max Weber* (1971). After focusing on the plan as his central conception of individual human action, Lachmann asks about 'the interrelationship between the actions of various actors' (1971: 49). When the success of each individual's plan depends on the success or failure of the plans of millions of others, how are we able to acquire information about those plans of others? In the face of this apparent ignorance of others' plans, how does social co-ordination ever come about? The answer, according to Lachmann (as taken from Weber) is through social institutions.

This question, in a variety of forms, is one that has been woven through Austrian economics for many years. From Menger's (1985 [1883]) original emphasis on undesigned institutions, to Hayek's (1937) definition of equilibrium in terms of plan co-ordination, to O'Driscoll and Rizzo's (1985: 86) discussion of 'pattern coordination', which 'involves the coordination of plans but not of actual

activities', Austrians have always asked a version of Lachmann's question.[5] The novelty of Lachmann's answer was that it reminded Austrians of their roots in the Germanic sociological tradition of Weber, Georg Simmel and Alfred Schutz.[6]

Central to that tradition, especially in its Weberian extensions, was the role of institutions as social co-ordination processes. In Lachmann's conception, institutions:

> enable each of us to rely on the actions of thousands of anonymous others about whose individual purposes and plans we can know nothing. They are nodal points of society, coordinating 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: 50)

Lachmann ties the role of institutions into Austrian conceptions of divided and contextualised knowledge. In a generalised version of Hayek's (1945) pioneering work on how the price system enables us to have access to knowledge that would otherwise be incommunicable, Lachmann suggests that Weber's theory of institutions points us towards seeing all economic and social institutions as communication processes that make our diverse and often tacit knowledge socially usable.

This aspect of institutions figures prominently in Langlois's extensions of Lachmann's work. He describes institutions as 'interpersonal stores of coordinative knowledge; as such, they serve to restrict at once the dimensions of the agent's problem-situation and the extent of the cognitive demands placed on the agent' (Langlois 1986b: 237). In the context of game-theoretic applications, Langlois (1986c) discusses how institutions enable us to solve 'coordination' problems. By everyone agreeing (whether explicitly or tacitly) on a particular practice, we no longer have to out-guess or out-strategise other actors. The classic example of such a co-ordination problem is which side of the road to drive on. As long as all agree, the particular choice is irrelevant. Knowing which side others will drive on lowers 'the extent of cognitive demands' in specific situations. Important in Langlois's formulation is that by removing some elements of social interaction from conscious deliberation, institutions free us to focus on other situations that lack institutional solutions:

> the existence at higher levels of institutions that stabilize the environment and reduce environmental entropy effectively frees behavioral entropy for use at lower levels. In a stable regime, the agent's reliability is high enough that he can add new actions to his repertoire . . . at lower levels.
>
> (Langlois 1986c: 186–7)

This idea parallels the oft-quoted dictum of Alfred Whitehead that 'Civilization advances by extending the number of important operations which we can perform without thinking about them' (as quoted in Hayek 1960: 22). In the light of an Austrian approach to institutions, we can interpret 'civilisation advances' as a proxy for 'as institutions evolve and mature'.[7] By serving as co-ordinative nodes, institutions reduce the knowledge needed to execute our plans, and enhance our ability to execute those plans successfully.

Given this description of what institutions do, Lachmann and others have pursued the question of how institutions come about. In short, institutions emerge as the unintended consequence of successful individual acts of rule-following behaviour. Individuals trying to improve themselves construct plans of action and attempt to carry them out. Individuals will continue to use modes of behaviour that are successful and will treat them as 'rules-of-thumb' as to how to act in certain circumstances. To the extent the ways of behaving exhibited in the successful plans can be observed by others, they will be imitated, increasing the number of actors behaving in particular ways. As this imitation process continues, and the number of users of particular rules-of-thumb increases, people learn to expect similar behaviour from others. A larger number of rule followers makes using the rule more attractive to potential newcomers as more users mean more opportunities to use the rule as a predictor of behaviour, enhancing the likelihood of co-ordinated outcomes.[8] When the behaviour in question is so widespread that we can call it 'generally accepted', the rule-of-thumb has become a social institution.

As Lachmann describes it:

> Successful plans thus gradually crystallize into institutions. . . . Imitation of the successful is, here as elsewhere, the most important form by which the ways of the elite become the property of the masses. . . . Institutions are

> the relics of the pioneering efforts of former generations from which we are still drawing benefit.
>
> (Lachmann 1971: 68)

Lachmann and others in the Austrian tradition point to Carl Menger's (1892) theory of money as the exemplary story of institutional emergence and evolution.[9]

An Austrian conception of social order sees it as an interconnected set of institutions, most spontaneous, some designed and all evolving and serving as communicative processes that enhance the ability of individuals or collectivities (such as firms) to formulate and execute their plans. The next, and perhaps more important, question deals with the relationships among all of these institutions. In Lachmann's (1971: 69) words: 'how can we know that these undesigned products of individual pursuit will all be compatible with one another?' Just how do the various institutional arrangements of a modern society interact to form what might legitimately be called an 'institutional order'?

Both Lachmann and Langlois offer us a way of conceptualising this order that enables us to say something about the relationships among institutions. For Lachmann, the crucial distinction is between 'internal' and 'external' institutions:

> the undesigned institutions which evolve gradually as the unintended and unforseeable result of the pursuit of individual interests accumulate in the *interstices* of the legal order. The interstices have been planned, though the sediments accumulating in them have not and could not have been. In a society of this type we might then distinguish between the *external* institutions which constitute, as it were, the outer framework of society, the legal order, and the *internal* institutions which gradually evolve as a result of market processes and other forms of spontaneous individual action.
>
> (Lachmann 1971: 81, emphasis in original)

Although Lachmann, on the following page, admits some shortcomings to this scheme, he also claims it is one in which a 'praxeological theory of institutions . . . most readily finds its place' (ibid.: 81). As seen in the lengthy quote above, Lachmann's prime example of an 'external' institution is the legal order in so far as market institutions emerge and evolve by taking the law as a given framework within which to develop. For example, given the framework provided by contract law, what sorts of practices will banks and their customers develop to engage in lending activities? The institution of a mortgage is internal to the external legal order of contract law.

Along the same lines, Langlois argues for a 'hierarchy' of institutions. For example: 'Highest-level institutions coordinate the highest level of plans. Institutions at lower levels coordinate lower-level or more concrete plans . . . lower-level institutions "grow" on the trellis of higher-level institutions' (Langlois 1986c: 185–6).

One can imagine all sorts of visual metaphors that capture the points both Lachmann and Langlois wish to make. One that seems in the spirit of both is to visualise institutions as concentric spheres, with the outermost spheres being the most 'external' or 'highest-level' institutions, which provide the framework within which the more inner spheres can arise. This image is compatible with all of the observations that Langlois (1992) makes concerning the relationship between internality and externality and Hayek's distinction between orders and organisations. My point is that such a visual metaphor seems to capture the essence of what both Lachmann and Langlois are articulating, even if it is not consistent with all of the details.

Before I proceed to argue why these hierarchical conceptions are problematic, let me recognise the important insight they contain. It is surely true that when we theorise or act, we treat many institutions as 'given' or at 'higher levels'. It is crucially important to realise that both describing and participating in the evolution of specific institutions always take place within a framework of institutional practices that are treated as stable. What Lachmann and Langlois are saying is largely correct. What I wish to object to is the implication, if not the explicit argument, that the hierarchy of institutions is something objective, even at a specific moment in time.

Subjectivism and the institutional order

One of the most important subjectivist insights of the past few years, particularly in its hermeneutical version, has been the emphasis on the actor's interpretive perspective in understanding both human action and economic theory. A thoroughgoing subjectivism sees 'the market' as the outward manifestation of the interpretive acts of the myriad actors who comprise it. What 'the market is saying' to individuals is not something objectively known

by all, but can only be understood with, at the very least, some reference to the perspective of the individuals in question. Trying to define or explain market processes without taking into consideration the differing subjective perspectives of actors is highly problematic.

Starting where Lachmann surely would have, we note that Austrian economics began with Menger's subjective theory of value. In that theory, a good's value could not be defined by its objective characteristics, rather only by its role in the purposes and plans of individual actors. In contrast to the labour theory of value, which saw the value of outputs determined by the value of the labour inputs that comprised them, the subjective theory of value saw the value of inputs deriving from the value of consumer goods, which itself derived from the minds of choosing individuals. In the same way, I want to argue that which institutions are internal or external, or which ones are higher or lower, depends on either the question the theorist is asking or the plan an actor is considering. Just as a specific good has value only in the contexts of individual actors, so can institutions only be ordered hierarchically in the context of a specific theorist or actor.

Another way to see this is to analogise it to subjectivist epistemology for a moment. From the simple insight that all facts are theory-laden to more sophisticated work in the theory of knowledge, it is generally accepted that humans do not see the world unmediated. As Hayek's (1952) work on theoretical psychology argues, the mind is an ordering process. How we perceive the world today depends on the various abstractions that the mind has evolved in the past. Thus, any given sensory ordering depends to at least some degree on the particular history and experience of the perceiver. In language more congenial to interpretive philosophical approaches, we always understand 'from' somewhere. As noted earlier, this same idea appears in the work of Michael Polanyi (1958: 55ff.), who argued that our focal awareness (i.e. what we are focusing on now) depends upon a certain subsidiary awareness (i.e. the framework we take for granted when we focus). To some extent, these philosophical ideas cohere with the hierarchical conception of institutions in that they stress the givenness of some aspects of the world when we turn to examine others.

However, what the philosophical literature also emphasises is that what is given, or what is subsidiary, or which experiences have created certain neural linkages, *cannot be understood as objectively the same for everyone*. Each person's 'facts' are laden with different theories, for example. This is the fundamental challenge to the notion of a reality that is objectively knowable in its purest form.

The danger with the hierarchical conception of the institutional order (as in the sphere analogy from earlier) is that it implies that some institutions are objectively external to others. Notice, too, that the point is not that the 'position' of institutions might change over time. Most theorists of institutions agree that the hierarchy of institutions today may be different from the hierarchy tomorrow. That is clearly true. The point here is deeper; we cannot objectively define which institutions are where in the hierarchy even at a point in time. The 'hierarchical order' of institutions is contextual to the question or action under consideration.

It is also true that the different 'levels' of institutions can have feedback effects on one another. For example, changes in the structure of firms may call for a reinterpretation of aspects of property or contract law, or a new banking practice may lead to changes in the institutional arrangements of the money supply process. My point is not just to say that such feedback effects occur. Austrian institutionalists recognise this point. However, taking those feedback effects seriously should imply that as such effects occur, they force analysts and actors to reverse the hierarchical relationships among the institutions in question.

If one wants to understand the evolution of contract law since the mid-1700s, one will have to take certain institutions as 'external' to the law. Surely such an evolutionary explanation will show how actual commercial activities exposed 'gaps' in the law that were filled by judicial interpretation and application of the existing law to the new circumstances. When a legal historian performs this task, he can be seen as offering an explanation of the evolution of an institution within the framework provided by market institutions and the monetary order. Judicial decisions cause the law to evolve against a background of given market practices. In this story the 'fixed' institutions are those of the market, while the evolving practices are the legal rules. Of course if one wanted to explain why modern corporations have the structure they do, some portion of that story would illustrate how that structure emerged as a response to existing contract and property law. In such a case the legal order is external to the market process.

Moving away from theory to actual practice, the same point applies. The judge making case law is, in effect, treating his institution as internal to the market order, much as the owners deciding how to structure their firm have to treat it as internal to the legal

order. Again, where particular institutions are in the hierarchical structure will vary depending on the perspective one is taking on the issue at hand.

To avoid any premature charges of nihilism, I am not arguing that we throw out all of the valuable insights provided by hierarchical metaphors. Instead I would suggest that we reconsider our metaphors to make them more consistent with a radically subjective understanding of both knowledge and the social order. After offering an alternative way of conceiving the institutional order, I will briefly discuss an application.

Parallels between Austrian theories of institutions and capital

An alternative way to conceptualise the institutional order might draw from Austrian analyses of another, equally complex, interconnected economic structure: capital.[10] In fact, Lachmann used the same phrase 'nodal points' to describe both institutions (see the quote above on p. 145) and capital goods: 'Capital goods are merely the *nodal points* of the flows of input . . . which they absorb, and of output . . . which they emanate' (Lachmann 1978: 58, emphasis in original). Austrian approaches to capital are the logical extension of subjectivist value theory. Once it is recognised that value is the product of consumer perceptions, then capital goods have to be understood in their roles as possible contributors to the production of valued goods. Since production does not occur automatically, but rather reflects the choices of producers/entrepreneurs, the way capital gets used will reflect the purposes and plans and expectations of its users. Whether a given good is capital depends on the role it plays in producers' attempts to anticipate the valuations of consumers. Production is inherently speculative as owners of capital 'bet' on it producing what consumers desire.

The implication of this theory of capital is that, as with value, the capital status of a good is not amenable to some objective definition. It is not the physical properties of a good that make it capital, rather it is the good's role in the plans of producers that give it the quality of being capital. The same slice of bread I use to make my ham sandwich at home would be considered capital if used for a restaurant sandwich and then sold to diners.[11] In a more complete discussion, stemming from Menger (1981 [1871]), we can recognise that capital goods can be 'ordered'. If consumer goods are 'first-order' goods, then the immediate inputs that comprise them are 'second-order' goods, and the inputs into those inputs are 'third-order' goods, etc. Such a schema gives the analyst a nice way to locate a specific good in the whole production process.

However, as with the hierarchical metaphors used in discussion of institutions, the danger here is in forgetting that the place of a specific good in this hierarchy is not objectively definable. For example, flour might be second-order for a bakery-made cake bought directly by consumers. On the other hand, the very same flour might be of a much higher order if it goes to a large commercial bakery that makes breads that are then sold to various food-supply wholesalers. Austrian capital theorists, especially Lachmann (1978), have long recognised the essential subjectivity of the concept of capital. In fact, one reading of the failure of Austrians to convince mainstream critics during the two debates of the 1930s (with Keynes and the market socialists), was that no one, including perhaps the Austrians, really understood the centrality of a subjectivist capital theory to understanding the market process. As we conceptualise the relationships among institutions, we should bear in mind the analogy from the capital 'structure'. Where a particular institution falls in the institutional order depends on the question we are asking.

Another set of concepts that can be taken from the Austrian theory of capital are 'complementarity' and 'specificity'. As Lachmann argues, capital is essentially heterogeneous implying that:

> each capital good can only be used for a limited number of purposes. We shall speak of the *multiple specificity* of capital goods. . . . For most purposes capital goods have to be used jointly. *Complementarity* is of the essence of capital use.
> (Lachmann 1978: 2–3, emphasis in original)

When producers formulate plans, they have to understand the range of possible uses for each capital good and how each good might fit with other goods needed to execute the plan at hand. In addition, as external circumstances (e.g., consumer demands) change, existing capital combinations may no longer be appropriate, and a reshuffling of capital must occur. How capital will be reshuffled depends greatly on how specific it is and how complementary it will be with other newly required capital goods. This constant arranging and rearranging of the capital structure is driven by the ever-changing demands of consumers.

Many of these same concepts could be applied to the institutional order. Certainly complementarity is a central concept in discussing institutions. How well institutions mesh together is crucial to their epistemological roles. One of Lachmann's (1971: 75ff.) four characteristics of institutional order is 'over-all complementarity'. He argues that clusters of related institutions might have high degrees of complementarity (e.g., all of those involving written or oral communication), but the relationships among clusters are not always so 'gapless'. For Lachmann, the 'gap' metaphor is a way of fleshing out how complementary a set of institutions is. He says of the legal system: 'It has no "gaps". A judge before whom a legal case is brought can never refuse to give a decision on the grounds that he knows of no legal norm to apply to it. He has to find one' (Lachmann 1971: 76–7).

Interestingly this same notion of 'gaps in the structure' appears in his discussion of capital and the way in which new investor-entrepreneurs see opportunities for profit: 'The shape in which new capital goods make their appearance is determined largely by the existing pattern, in the sense that "investment opportunities" really mean "holes in the pattern"' (Lachmann 1978: 10). In both cases, what is at issue is the *internal coherence* of each structure, rather than some externally observable objective pattern (ibid.: 57).

Rather than seeing institutions as in hierarchical relationships with each other, a more fruitful conceptual device might be an exploration of the ways in which they can work together and the limits to such complementarity. Concerns about institutional complementarity are inherently linked with real historical time and unexpected change. How social order can be preserved in the face of an unknowable but not unimaginable future may well rest on the ease with which different institutions can work together in various combinations to react to and anticipate (to the degree possible) future events.

The issue of specificity also comes into play with institutions. Rather than examining how a particular institution fits with others, the specificity of an institution might refer to its own adaptability in the face of social change. The flexibility of institutions may be crucial for providing social order. An example of this might be seen in the way in which many indigenous institutions in the Third World have changed and adapted to being further permeated by market forces.[12] Overly specific institutions may inhibit social order by being insufficiently flexible.

Linked with specificity is the fact that institutions display a high degree of path-dependency. Institutions always change and adapt from their earlier incarnations; they normally cannot be constructed whole cloth. Path-dependency also suggests that objectivist measures of optimality (such as Pareto criteria) are difficult to apply in an Austrian view of institutions. Institutions are never likely to be perfectly fitted for solving existing problems because they are the products of imperfect processes of historical evolution. Just as a relatively specific capital good refitted to perform a task different from its original one may not do so as well as a new machine, so are many institutions imperfect adaptations to existing social environments.[13]

Of course, completely non-specific institutions are likely to be problematic also, since they would have to be at a level of generality that would probably require other sorts of (complementary!) institutions in order to generate concrete co-ordinative results. An example here might be language. Language is extremely flexible (though perhaps not perfectly). However that very flexibility creates the problem of jargon or dialects that make linguistic co-ordination more difficult. Other social institutions might be necessary to enable language to adapt smoothly to outside change. An example of this might be the technospeak of the very computer-literate compared to the average person's understanding of such issues. The very flexibility of language can create communication barriers.

One problem all institutions face is being sufficiently flexible to adapt to the unexpected, yet sufficiently coherent to serve as nodal points for current attempts at co-ordination. With capital goods, complementarity and specificity are ways of conceiving these issues. As conditions change, producers have to work with capital goods of distinct specificity and reshuffle them into complementary combinations that will meet the new change. Transferring the same concepts to institutions might provide a useful way of conceiving the institutional order without positing some objectively given, hierarchical structure. Thinking of institutions as nodal points of co-ordination that are constantly in motion and shuffling and reshuffling their relationships with each other need not lead to theoretical chaos. The profundity and longevity of the Austrian theory of capital attests to how such a theory (even when insufficiently developed) can provide important insights and be radically subjectivist.

Banking and the law: an illustration

A quick overview of the relationship between the growth of financial intermediaries and the evolution of the relevant portions of the law can illustrate the complex and varied relationships among institutions and the difficulties of viewing them as hierarchical. The evolution of banking provides some excellent examples of complementarity and specificity and the flexibility/coherence balance.[14]

It is generally argued that what we now understand as financial intermediaries probably grew out of earlier institutions that were simply warehouses for storing precious metals. Traders who did not wish to undertake the risk of holding large stocks of gold could store them for safekeeping with goldsmiths or others who offered security for a fee. At first, transferring these gold 'balances' was cumbersome as the law often required the presence of both parties to the transfer and perhaps their legal representatives in order to execute the exchange of gold. At this point, the proto-banks were acting within the given legal order and using the accepted processes of transfer.

However, entrepreneurial gold storers realised that transfers could be made more easy by issuing receipts to gold in storage and allowing traders to simply exchange those receipts (via endorsement) rather than by actually meeting at the storage facility and signing the relevant paperwork. The issue facing this innovation was how the legal order would interpret those receipts and the use of signature endorsements to transfer them. This uncertainty reflects a missing complementarity between two institutions. In most cases, the law recognised the receipts as contractual obligations and endorsement as an acceptable transfer process.

This issue also illustrates a limit of hierarchical metaphors. To the extent that the popularity of this banking innovation put pressure on the legal system to decide on their status, it reflects the degree to which legal institutions were 'internal' to financial institutions and practices. However, once such a decision was made, banks could treat the legal status of such receipts as given and move to innovate further, thus treating the legal order as 'external'. The metaphor of complementarity seems much more appropriate here.

One of the next major steps in the evolution of banking was the move to fractional reserve banking. Once again, entrepreneurial warehousers realised they could profit by lending out deposited specie at interest to the extent that depositors had no direct use for it. The transferring of receipts had diminished the actual amount of metal that flowed in and out of the 'bank', facilitating the move to fractional reserves. Early bankers understood that the challenge was to maximise their interest returns while still maintaining sufficient reserves to meet the demands of depositors.[15] The question that needed to be answered was how the legal system would interpret deposit receipts in the absence of 100 per cent reserves.

Whereas deposit receipts under 100 per cent reserve banking are effectively bailments, not unlike the receipt one might have for furniture at a self-storage facility, fractional reserve bank notes cannot be seen this way. The exact legal standing of the contract between a depositor and a fractional reserve bank has been the subject of much discussion among Austrian monetary theorists.[16] Historically, however, the law has generally seen those contracts as *demand* deposits, in that the legal obligation of the bank is to redeem bank notes when customers demand it.[17] Under this interpretation, the bank is free to do what it pleases with the specie as long as it can deliver the required amount when demanded.[18] In this case again, the legal order had to respond to an innovation coming from the financial sector. As both note users and issuers generally began to find fractional reserve notes to be acceptable, judges worked within that set of practices in establishing the legal standing of the notes. Again, however, having established the acceptability of fractional reserve notes, banks now treated the law as external and were able to pursue other related innovations with the assumption that the legal order would treat such innovations the same way.

One example might be the decision to give borrowers bank notes (or deposit credits) rather than actual specie. Banking historians generally agree that banks first lent actual specie and somewhat later realised they could lend out notes rather than specie. With the uncertain legal standing of fractional notes, banks were likely to have been hesitant to use them for all customers at first. Once the law indicated it would accept such notes as redeemable on demand, then banks probably extended the practice to new borrowers rather than just to old depositors. The complementary interrelationships between banking and the law are clearly illustrated here.

One last banking innovation that reflects issues of complementarity and specificity is the 'option clause'.[19] Scottish banks during their free banking period in the eighteenth century developed a way of dealing with the danger of massive withdrawals that could drain a fractional reserve bank by rewriting the contract contained in a bank note. Rather than being redeemable 'on demand', their notes

were redeemable on demand or in six months at 5 per cent interest, at the bank's discretion. The notes gave the bank the option of suspending redemption for a limited period of time with compensation paid to the note holder.

This innovation can be viewed as an example of institutional flexibility in the face of uncertainty. Scottish banking practices were not so institutionally specific as to be unable to react to external change. At first, the Bank of Scotland simply unilaterally declared that note redemption would be suspended for some period and interest would be paid to note holders, without having specified this in writing on the note. This *ad hoc* policy was used on three occasions in the early 1700s (White 1984: 25–6). Eventually, such *ad hoc* manoeuvres faced legal challenges.

The period (1727–30) during which an actual option clause was added to Scottish notes was one of new entry and intense competition (Dowd 1991: 769). Faced with the uncertainty inherent in such a situation, the Bank of Scotland first used the *ad hoc* invocation of temporary suspension with interest to prevent itself from being drained of reserves by a new competitor, the Royal Bank of Scotland. In this case, however, a suit was brought charging the Bank of Scotland with violating the terms of its charter by not redeeming notes on demand. According to White (1984: 26): 'After much legal wrangling the note holder's right of "summary diligence" or immediate payment on Bank of Scotland notes . . . was upheld'. Shortly after this decision, the Bank of Scotland added an explicit option clause on the obverse of all of its notes indicating its right to suspend redemption and the corresponding payment of interest.

The problem facing both the banks and the law was how to be sufficiently flexible to deal with the challenges of innovation and uncertainty, while still maintaining a coherence and complementarity that could provide a stable institutional environment for market actors. The whole Scottish option clause episode can be seen as an attempt to fill in the 'gaps' in both the monetary and legal institutional orders.[20] Judges had to react to financial innovations, and banks had to wait to learn the official legal status of their innovations before extending or advancing on them. It would be difficult in this case to point to either the legal or monetary order as being internal or external or up or down in some hierarchy. Rather it seems more like a story of shuffling and reshuffling and searching for complementarity in the face of external change, much like the Austrian theory of capital.

This illustration indicates that the complexities of historical processes of institutional evolution cannot be fully captured by hierarchical conceptions of institutional order. A more subjectivist view of institutional order would seek out more circular or interactive relationships among institutions. The evolution of any specific institution will indeed proceed against the backdrop of other institutions, but may also *affect* the future evolution of those other institutions. Our approach to institutional evolution needs to be forward-looking as well, by understanding the unintended consequences that emanate from individual institutional change. The idea of 'co-evolution' and notions of complementarity and specificity should begin to play more prominent roles in Austrian conceptions of economic and social institutions.

Conclusion

One of the subtexts of this chapter has been the claim that it is not accidental that Ludwig Lachmann was a pioneer in both Austrian capital theory and the theory of institutions. Both theories and their subject matters share important characteristics. What they share most, though, is that they are both rooted in a subjectivist approach to social phenomena. That subjectivism is Lachmann's true legacy. However, consistently adhering to a subjectivist paradigm is a continual challenge. Debates over equilibrium theory among Austrians, and debates between Austrians and post-Keynesians concerning the theoretical and political implications of subjectivism demonstrate this challenge quite vividly. As subjectivists pursue a theory of institutions, we need to be careful not to accidentally drift from the friendly seas of subjectivism into the rapids of mechanistic, hierarchical or objectivistic conceptions of the institutional order. Extending Lachmann's legacy demands no less of us.

Notes

1 For a larger treatment of these issues in the post-revival generation of Austrians and their relationship to Menger's original work, see Vaughn (1994).
2 In that sense, my mission parallels that of Prychitko (1994) who argues that Lachmann's focus on 'the plan' is untrue to Lachmann's own professed hermeneutic orientation as it ignores or downplays the unintended consequences of the playing out of individual plans.
3 Of course there are numerous other treatments of institutions. A variety of perspectives can be found in Hodgson (1988); Mäki *et al.* (eds) (1993); and Rutherford (1994), among others. Explorations of the relationship between Austrian economics and the Old Institutionalism (from each side) can be found in Boettke (1989) and Samuels (1989).
4 For my own partial attempts at such work, see Horwitz (1992a, 1993, 1994).
5 Philosophically this question is also at the bottom of modern phenomenology. As the Austrian philosopher Alfred Schutz put it: 'What makes my behavior social is the fact that its intentional object is the expected behavior of another person' (Schutz 1967: 149).
6 On Schutz and the Austrians, see Prendergast (1986). On Simmel and the Austrians, see Horwitz (1992b).
7 There is also a parallel here to Michael Polanyi's (1958) distinction between 'focal' and 'subsidiary' awareness. I shall return to this issue later.
8 This phenomenon is frequently referred to as a 'network effect', as in a telephone network. With any network or other communication process (like language), the more users there are, the more attractive is the process to potential participants. A phone network with only three users is not very attractive compared to one with millions.
9 Indeed, note my use of the phrase 'generally accepted', which is normally associated with the definition of money as a 'generally accepted medium of exchange'. One can extend that definition to other social institutions by changing the practice that is being generally accepted. For example, one might define law as a 'generally accepted set of rules for interpersonal interaction'. For more on the parallels between money and law, see Horwitz (1993).
10 Lachmann's capital theory is seeing a bit of a revival. See Horwitz (1994) and Lewin (1994 and 1997).
11 Of course one could argue that my bread is capital too, in that the sandwich is a 'capital' good that produces utility. Although that insight is in some sense true, it is also trivial. A better way of conceiving the issue is in terms of trade on a market. Capital goods have market prices, as do the items they produce. The ham sandwich I make and eat is, in Marxian terms, not a commodity; the restaurant sandwich is. The commodity status of the product confers capital status on the inputs. It is neither accidental, nor incorrect, that Marx started *Capital* with a discussion of the commodity.
12 See, for example, Chamlee (1993).
13 The analogies to evolutionary biology are obvious here. For more see Horwitz (1992a: Chapter 2) and Hodgson (1992). Darwin himself understood that existing biological species will not meet criteria of perfection: 'We cannot doubt that each structure is of use to each kind of squirrel in its own country . . . [b]ut it does not follow from this fact that the structure of each squirrel is the best that it is possible to conceive under all possible conditions' (Darwin 1859: 129).
14 This section draws on the work of Selgin and White (1987) and extensions of that work in Horwitz (1992a: Chapter 4).
15 The two criteria necessary for fractional reserve banking are that the medium of exchange is fungible and that withdrawal patterns are sufficiently random so that the law of large numbers can be said to hold. If

the law of large numbers holds, then the chance of any significant amount of withdrawals on any given day is small, enabling banks to hold fractional reserves.

16 See Rothbard 1983: Chapter 1.

17 One of the ironies of the 100 per cent reserve position is that its adherents correctly recognise the historicity of the particular goods that get used as media of exchange, but forget the importance of historical evolution when discussing the legal standing of fractional reserve notes. They wish to impose a legal/ethical theoretical position by *fiat*, despite the historical evolution of case law on that practice. To this extent, the more 'traditional' Austrian view on banking was very much non-institutional, and a more subjectivist and institutionalist view would stress the complementary evolution of financial institutions and legal practices.

18 One interesting issue here is whether the bank has a legal obligation to maintain the purchasing power of the specie while it is in its custody. Some Austrian defenders of 100 per cent reserve banking argue that fractional reserve banks by definition depreciate the value of specie, thus violating the bank note contract. The validity of this argument depends on one's definition of inflation/depreciation and the role of the demand for money, issues which are beyond the scope of this paper. See Horwitz (1988) for more.

19 A good overview and defence of this practice is in Dowd (1991).

20 Interestingly enough, option clauses were eventually outlawed in Scotland in 1765. Various players in the banking industry were willing to give up the right to the option clause in exchange for differing political favours. Provincial banks wanted full legal recognition and the chartered banks wanted to politically eliminate their competition. The provincial banks eventually won and the option clause and small denomination notes were the price. See the accounts in Dowd (1991) and White (1984).

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9

LACHMANN'S POLICY ACTIVISM

An Austrian critique of Keynesian proclivities

Peter J. Boettke and Steven T. Sullivan

Introduction

W. H. Hutt, upon noticing that Ludwig Lachmann was to be one of the main lecturers at the first Austrian Economics Instructional Conference in South Royalton, VT in the summer of 1974, supposedly turned to a crowd of students and said, 'Why is Lachmann here? He is a Keynesian, not an Austrian.' Hutt, one of the foremost critics of Keynesian economics, was someone with authority to comment on this issue. Indeed, why was Lachmann there if he possessed Keynesian proclivities in public policy?[1] Roger Garrison, perhaps the leading contemporary authority on Austrian macroeconomics, often refers in lectures to Lachmann's approach to economics as 'Austro-Keynesianism'.[2] There can be no doubt that in the history of Austrian economics, Lachmann was the most charitable interpreter of Keynes within the Austrian tradition. Indeed, in a 1983 essay Lachmann sought to delineate the common ground that existed between Keynes and his followers and the Austrians.[3] Lachmann adhered so consistently to the 'principle of charitable interpretation' with respect to Keynes and many other of the Austrian School's rivals that it became known around the NYU colloquium as 'Lachmann's Law'.[4] Mises and Hayek certainly lacked both the patience and the intellectual sympathy required to deal with Keynes in the manner that Lachmann did. Those familiar with the history of Austrian economics will also note that when Lachmann's subjectivism is mentioned, Keynes and Shackle are never far behind.