# Economists and Liberty:

# Ludwig M. Lachmann (1906-      )

## by Peter J. Boettke

In the mid-1970s Ludwig M. Lachmann breathed life into an intellectual movement that was all too confident of its answers to current problems and its critics. The sense of Humean skepticism that Lachmann brought to the American Austrian revival was necessary for the intellectual growth of a school of thought dedicated not only to changing the nature of economic thinking, but to changing the world.

### Prelude

With the death of Ludwig von Mises in 1973, leadership of the American Austrian school of economics was divided between Murray N. Rothbard and Israel M. Kirzner. The turbulence of the Vietnam War produced a young libertarian movement, which split from the conservatives in the late 1960s (c.f., Jerome Tuccille, *Radical Libertarianism* Harper and Row, 1971). Rothbard emerged as the theoretical guru of this movement, and his books and pamphlets excited many young people about the potential for radical change in society. Those who were attracted to Rothbard's vision of an individualist society were naturally drawn to Austrian economics. While Rothbard stirred intellectual excitement about a revolutionary movement, the careful and patient scholarship of Professor Israel M. Kirzner was improving our understanding of the market process (e.g., *Competition and Entrepreneurship*, University of Chicago Press, 1973). Hayek's receipt of the 1974 Nobel Prize in economics spurred further interest in Austrian economics, and with the support of institutions such as the Institute for Humane Studies and Liberty Fund, the Austrian revival was under way.

Kirzner, the major architect of the revival, followed his own theory and exercised perceptive entrepreneurial alertness to bring Ludwig M. Lachmann from the University of Witwatersrand, South Africa to New York University as a Visiting Professor of Economics, where he has spent at least half of each of the last twelve academic years. The Austrian movement has never been the same. Lachmann has challenged young Austrians not to be content with the answers that Murray Rothbard's pamphlets presented. Rothbard (who will be dealt with separately in another installment of this series) is a major inspiration to modern libertarians and Austrian economists, but suffers (as does Ayn Rand, another such inspiration) from a confusion between correct intuition about first premises and a completed argument. Though he is a brilliant and charismatic fellow, with the ability to change a person's life, he is (similar to Rand) also intellectually and personally oppressive—a self-avowed Leninist on strategy (c.f., Rothbard, *Toward a Strategy for Libertarian Social Change,* Center for Libertarian Studies, unpublished m.s., n.d.).This aspect of Rothbard, which is most strongly felt in his activity within the libertarian movement, has also damaged Austrian economics, and the advancement of the ideas of Menger, Mises, Hayek, and *Rothbard*. Kirzner's careful scholarship and thorough-going commitment to improving and advancing Misesian economics, and Lachmann's persistent questions have prevented Austrian economics from becoming the religious dogma of the Rothbardian cult. The thought of Israel Kirzner will be the subject of the next essay in this series. Here, it is my task to summarize Lachmann's contribution to our economic understanding, and the implications of this understanding for economic and political liberty.

### Intellectual Background

Walter Grinder, Vice President of the Institute for Humane Studies at George Mason University, provided a great service to students of Austrian economics by compiling, editing, and introducing a collection of Lachmann's major essays on the nature of the market system; *Capital, Expectations and the Market Process* (Sheed, Andrews and McMeel, 1977). In particular, Grinder's introduction is an excellent interpretive essay on Lachmann's intellectual development and significance to our understanding of the price system. The following draws freely upon Grinder's essay ("In Pursuit of the Subjective Paradigm," op. cit., pp. 3–24).

Ludwig M. Lachmann was born in 1906, in the Berlin of the Weimar Republic. In 1924 Lachmann entered the University of Berlin, and studied economics under Werner Sombart, receiving his PhD in 1930. During this period he had the opportunity to visit the University of Zurich in the summer of 1926, where he was introduced to subjectivist economics, and the writings of Carl Menger in particular, for the first time by Manuel Saitzew, a Russian-born economic historian.

Lachmann returned to Berlin, and began studying monetary and business cycle theory. His tutor in economic studies was Emil Kauder, who shared an interest in the Austrian school. Kauder emphasized the importance of the Austrian emphasis on subjective evaluations in understanding economic phenomena. Kauder himself has written several fine articles, and a book on the intellectual origins and development of Austrian economics (c.f., "The Intellectual and Political Roots of the Older Austrian School," *Zeitschrift fuer Nationaloekonomie*, December 1957; *The History of Marginal Utility* Theory, Princeton University Press, 1956). Around this time, Lachmann stumbled across the methodological works of Mises, which integrated the economic thought of Menger, Friedrich von Wieser, and Eugene von Boehm-Bawerk with the interpretive sociology of Max Weber (c.f., Mises, *Epistemological Problems of Economics*, New York University Press, 1981). As Lachmann recalls:

> One day, I really don't know by what accident, I came across an article by Mises, who, you'll remember, started publishing methodological essays in the German journals in the late 1920s. I don't remember the first occasion on which I came across one of these articles, but I read it, and found it most interesting. In particular the Austrian economics Mises espoused seemed to be something rather different from what I knew from the textbooks. I got interested and read more Mises and this is how I became an Austrian (Richard M. Ebeling, "An Interview with Ludwig Lachmann," *Austrian Economics Newsletter*, Fall 1978, p.1).

With PhD in hand, Lachmann emigrated to England in 1933, where he became Hayek's research assistant. The world was ensnared by the Great

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Depression. The Mises/Hayek theory of the trade cycle was the talk of the town, but all was not right in London. Many began to argue that the Austrian theory was unable to explain the depth and severity of the depression. Lachmann's work centered on explaining secondary depressions. In this regard, Lachmann began to recognize the crucial role that expectations play in the explanation of the business cycle. The role of expectations has been the focal point of Lachmann's understanding of market processes ever since.

Lachmann travelled to the U.S. in 1938, as a research fellow of the University of London, to conduct research on the Great Depression. In the U.S. he visited and participated in programs at Harvard, Columbia, and the University of Chicago At Chicago, while participating in Frank Knight's seminar, he was introduced to Knightian criticisms of Austrian capital theory (c.f., Knight, "Professor Hayek and the Theory of Investment," *Economic Journal*, March 1935, "Professor Mises and the Theory of Capital," *Economica*, November 1941). In response, Lachmann began to restate the Austrian position, but the holocaust of World War II, and the mobilization of nation states for war proved too much for Austrian theory, especially since Keynesianism was so well suited for gearing up the war effort.

Lachmann was appointed a lecturer at the University of London in 1941, and then moved to the University of Hull in 1943, where he remained until 1948. In 1949, Lachmann became head of the Department of Economics at the University of Witwatersrand, Johannesburg, South Africa. He was appointed Visiting Professor of Economics at New York University in 1975.

## Methodological Principles

Lachmann has been one of the most vocal spokesmen for the special character of the human sciences, in general, and economics, in particular, in the past 50 years. Human sciences must begin with

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purposive human acts. As Carl Menger argued, "man, with his needs and his command of the means to satisfy them, is himself the point at which human economic life both begins and ends" (Menger, *Principles of Economics*, p. 108, New York University Press, 1981). In order to understand economic phenomena, economists must render the event under examination *intelligible* in terms of human action. Lachmann, following Mises, argues that sound economic reasoning must begin with reflection on the essence of human action. This leads to the recognition that only individuals face decisions and make choices, though undoubtedly conditioned by their social surroundings. Therefore, social phenomena are only rendered intelligible if the economist traces those phenomena back to individual decisions, i.e., methodological individualism.

Reflecting on human action, we discover that action is, as Mises described it, "will put into operation," and is always *in* time (*Human Action*, Henry Regnery, 1966, p.11). Human action is future-oriented; it is "always directed toward the future; it is essentially and necessarily always planning and acting for a better future" (ibid., p.100). Lachmann has concentrated his efforts on exploring the Misesian notion of the plan. His book, *The Legacy of Max Weber* (Glendessary Press, 1971), elaborates this notion of the plan, and plan formation, and demonstrates clearly the interconnection between the thought of Mises and Max Weber.

Social institutions, according to Lachmann, emerge and act as guideposts in the coordination of the separate and divergent plans of various individuals within a social setting. The market is not a place or thing, the social scientist should not be concerned with prices or quantities such. Rather, the market needs to be understood as the interplay of the various, and divergent plans of purposeful human actors. And since plan formation is an activity of human thought, the market is best understood as the interaction of human minds. As Lachmann has most recently stated we must "view the market as a pattern of meaningful utterances of the human mind" (*The Market as an Economic Process*, Basil Blackwell, 1968, p. 165).

Perhaps Walter Grinder summed up Lachmann's and the Austrian position best when he stated:

> Since thought and action are identical categories, an understanding of thought will also furnish an understanding of action. To understand action is to comprehend the thought that sets the action in motion. *Interpretive economics* relates complex economic phenomena to the individual plans and purposes that set them in motion, and this analysis requires constant reference to the plans, preferences, values, and expectations of acting individuals (op. cit., p. 16, emphasis added).

This is why Austrians seem preoccupied with methodological discussion. Our goal is to understand purposive human action, and if "to understand action is to comprehend the thought that sets the action in motion," then the social theorist *must* be concerned with the nature of thought processes; individual, social, and scientific. Such abstract philosophies as phenomenology and hermeneutics, therefore, possess profound significance for our understanding of economic science as well as the liberal social order (c.f., Tom Palmer, "Gadamer's Hermeneutics and Social Theory," *Critical Review*, Vol. 1, No. 3, Summer 1987).

## Divergent Expectations and the Market Process

The most consistent theme running throughout Lachmann's life work has been the importance of expectations in his explanation of the market process. In this regard, Lachmann has been influenced greatly by G.L.S. Shackle, especially *Epistemics and Economics* (Cambridge University Press, 1972). Lachmann argues that the subjectivist revolution, which began with Menger and was carried out by Mises and Hayek, must be extended beyond the realm of values to expectations. The market system is fundamentally the interaction of various and divergent expectations. The crux of competitive processes is that some expectations are satisfied only at the expense of defeating others. The wonder of the market process is that out of this chaos, goods and services are allocated and delivered in an orderly manner. As Bastiat would say, "Paris gets fed."

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On a recent T.V. show, for example, a woman commenting on economic life in the Soviet Union said that when one lives in the Soviet Union questions occur to you that you never thought of before. "How is it, " she asked, "that back in the States cucumbers end up in ShopRight in January?" This question is the most fundamental question an economist can ask; in fact, it is the primary didactic function of economists to explain the spontaneous ordering of market activity (c.f., my "The Market is a Spontaneous Order: Part I," *Nomos*, Sept/Oct. 1986; "Part II," ibid., Nov./Dec. 1986). I would like to point out that the invisible hand, or spontaneous ordering of markets, is not an assumption from which economists begin to theorize. Rather, understanding spontaneous order is the result of theorizing. The cucumbers are on the shelf; we don't initially assume they are on the shelf; we try to understand how they got there, who produced them, and for whom they were produced.

Lachmann has emphasized that we cannot treat the market as clockwork or as a machine. We must recognize the inherent indeterminancy of market activity. Market interaction never settles down, or reaches a state of rest. Economic activity is not just concerned with price or quantity adjustments. The market is, rather, the continuous allocation and reallocation of goods and services within the rivalrous process of economic activity. In this regard, Professor Lachmann has been perhaps the greatest critic of the static and mechanistic theorizing that dominates most of economics (c.f., Matthew B. Kibbe, "Escaping the Paretian Paradigm," *Market Process*, Vol. 5, No. 2, Fall 1987).

In his rejection of the equilibrium metaphor of market activity, Lachmann takes inspiration from Mises. "Mises rejects the notion of equilibrium," he states, "and proposes to replace it by that of Market Process." By so doing, Mises requires his students to "tackle the uncomfortable task of substituting for it [the notion of equilibrium] something else, something at once more akin to reality and more congenial to praxeological thought." "Fortunately," Lachmann concludes, "we have Mises's work to guide us in this task" (*Capital, Expectations and the Market Process*, 1977 p. 188).

Lachmann's insistence on the rejection of the equilibrium mode of thinking has profound implications for the defense of the free market system. Though Lachmann does not share with Mises and Hayek the philosophical commitment to classical liberalism, he could be described as a traditional classical liberal. He generally believes in the workings of the market system, and the necessity of democratic values for the good of society. His insights, though, into the market process are indispensable for improving our understanding of the free market. Lachmann's persistent questioning about the nature of the profit and loss system challenges contemporary equilibrium defenses of the market system by theorists of the Chicago school variant, and even poses a challenge to traditional Austrian explanations that see the market as an equilibrated process. "If, with Mises," Lachmann argues, "we reject the notion of general equilibrium, but, on the other hand, do not deny the operation of equilibrating forces in markets and between markets, we naturally have to account for those disequilibrating forces which prevent equilibrium from being reached" (ibid., p. 190). We cannot merely assert, or assume that markets either coordinate perfectly, or possess a tendency toward perfect coordination.

Some economic forces work to bring about coordination of plans at the same time that other economic forces work to upset the plans of others. In fact, the very institutions (such as money, firms, advertising, etc.) which produce the mutually reinforcing expectations that define the market order *depend* on the market system being out of equilibrium (c.f., Ulrich Fehl, "Spontaneous Order and the Subjectivity of Expectations," *Subjectivism, Intelligibility and Economic Understanding*, Israel M. Kirzner, edited, New York University Press, 1986). It might be that a proper understanding of market phenomena will have to move beyond the spectrum of equilibrium–disequilibrium, and concentrate instead on explicating the ordering processes of human interaction which we call the market (c.f., David L. Prychitko, "Ludwig Lachmann and the Farther Reaches of Austrian Economics," *Critical Review*, Vol. 1, No. 3, Summer 1987; Boettke, Steve Horwitz, and Prychitko, "Beyond Equilibrium Economics," *Market Process*, Vol. 4, No. 2, Fall 1986).

It is not because the private property order and the system of freedom of exchange and production provide the best of all possible worlds that the Austrian economist favors free markets. Economic errors, such as business failures or bad investments, are a crucial aspect of the *profit and loss* system. The Stock Market Crash of 1987, for example, was not a sign of market failure, but the market reasserting itself in an economic environment of violent intervention by government into the financial system. As stock prices fell from August to October, the market was throwing off bad investments caused by government—manipulated credit markets. Government unwillingness to step out of the way and allow the market to 'correct' for past Federal Reserve-generated malinvestments signals that October was only a pang forewarning us of the coming financial heart attack.

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Even under an unregulated system of exchange and production, economic error is part of the driving force of market activity. What economists cannot do, however, is rely on an explanation of market phenomena that depends on the existence of *persistent* error. Individuals tend to revise their plans to account for past mistakes in judgement. This assessment and reassessment of past judgments and the judgements of others is what drives market interaction. As Israel Kirzner explains; "The market process emerges as the necessary implication of the circumstances that people act, and that in their actions they err, discover their errors, and tend to revise their actions in a direction likely to be less erroneous than before" (*Perception, Opportunity and Profit*, University of Chicago Press, 1979, p. 30). The market is a process in which individuals are forever arranging and rearranging their plans to meet the changing conditions, and coordinate themselves with the plans of others in the attempt to improve their state of affairs. Economic activity is a learning process.

The bias that Austrians share towards the free market, therefore, depends on the ability of that system to utilize and convey the various bits and pieces of knowledge necessary to allocate resources in a rational manner. "The market process," states Lachmann, "is the outward manifestation of an unending stream of knowledge. This insight is *fundamental to Austrian economics*. The pattern of knowledge is continuously changing in society, a process hard to describe. *Knowledge defied all attempts to treat it as a 'datum' or an object indentifiable in time and space*"(Lachmann, "On the Central Concept of Austrian Economics: Market Process," *The Foundations of Modern Austrian Economics*, edited with an introduction, Edwin G. Dolan, Sheed & Ward, Inc., 1976, p. 127, emphasis added).

This emphasis on the division of knowledge is the crux of the Austrian criticism of government intervention into a freely operating market; from attempts to replace the market with centralized economic planning, to piecemeal programs of intervention (c.f., Don Lavoie, *National Economic Planning: What is Left?*, Ballinger Press, 1985; Israel M. Kirzner, *The Perils of Regulation*, Law and Economics Center at the University of Miami, 1978). Government's inability to obtain the knowledge necessary to plan or regulate the price system is the fundamental *economic* criticism of either radical or piecemeal intervention into the market order. As Mises states; "This is the *decisive objection* that economics raises against the possibility of a socialist society. It must forgo *the intellectual division of labor* that consists in the cooperation of all entrepreneurs, landowners, workers as producers and consumers in the formation of market prices. But without it, rationality, i.e., the possibility of economic calculation, is unthinkable" (*Liberalism*, Foundation for Economic Education, 1985, p. 75, emphasis added).

## Time, Knowledge, and Capitalist Production

Lachmann, in his discussions of the market process, has always emphasized that all economic activity takes place in time. As such, a major concern of his has been the function and operation of capital markets within the broader scope of economic activity. Capital markets allocate resources through time to meet an uncertain future demand for consumer goods. Production is always for an uncertain future. Entrepreneurs and businessmen must make the best guess they can to attempt to either create or discover, and eventually meet that future consumer demand. As Mises states: "In the real world acting man is faced with the fact that there are fellow men acting on their own behalf as he himself acts. The necessity to adjust his actions to other people's actions makes him a speculator for whom success and failure depends on his greater or lesser ability to understand the future. Every action is speculation" (op. cit., 1966, p. 113). Part of that ability to "understand the future" is how to read, and acquire the necessary resources through established capital markets.

While standard economic theory treats capital as homogeneous, Lachmann has continuously pointed out that capital goods are generally heterogenous and specific. In his classic, *Capital and Its Structure*, Lachmann argues that: "The real economic significance of the heterogeneity of capital lies in the fact that each capital good can only be used for a limited number of purposes" (Sheed, Andrews and McMeel, 1978, p.2). This heterogeneity and specificity of capital goods implies that capital goods are complementary to one another, and will be utilized in capital combinations. These capital combinations make up what is referred to as the capital structure within an economy. But, since we are in an ever-changing world, these capital combinations will be forever changing. "We are living in a world of unexpected change;" argues Lachmann, "hence capital combinations, and with them the capital structure, will be ever changing, will be dissolved and reformed. In this activity we find the real function of the entrepreneur" (ibid., p. 13).

The problem with traditional methods of studying the capitalist production process lies in either treating capital as a homogeneous blob that reproduces itself, or relying on a momentary snapshot of the capital structure at some period of time. "It is not, however, a mere matter of time, but of human action in time" (ibid.). In contrast to either the "blob" method or period analysis, Lachmann emphasizes the process by which capital combinations are shuffled and reshuffled in the competitive quest for profits. "It thus seems clear that a study of capital problems in a world of unexpected change has to be conducted by means of process analysis, and that the application of this method presupposes a study of entrepreneurial expectations." And once we take into account the importance of entrepreneurial expectations, their formation and interaction with the expectations of others becomes of prime concern. "The formation of expectations is a moment in the *process of the acquisition of knowledge* and has to be studied as such" (ibid., p. 15, emphasis added).

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The knowledge embedded within the capitalist production process is tested and revealed within the profit and loss system. Economic actors acquire knowledge in the process of doing, as they try to outcompete their rivals by coordinating their plans with those of others in a more efficient manner. As David Prychitko has described this learning process: "The 'learning by doing' that Lachmann, Hayek, and the Austrians in general talk about has to do with following out one's plans and intentions, as one tries to interpret market signals in order to coordinate one's individual activities with the complex social world in which he finds himself" (op. cit., p. 71). It is the unique Austrian claim, moreover, that *only* the price system enables individuals to utilize and exploit this knowledge, acquired through the separate and various attempts to coordinate one's plans with the plans of others, in a manner consistent with advanced industrial production, and the maintenance of human prosperity, dignity, and freedom.

## Conclusion

Ludwig Lachmann has added indispensable insights to our understanding of the market order. He has served as the "Socratic Gadfly" of the Misesian system. He has challenged us to use our logic, not to be satisfied with traditional explanation, and to pursue the farther reaches of the Austrian paradigm. He is a great scholar who delights in asking difficult questions, and being asked difficult questions. He takes extreme pleasure in intellectual discourse. A friend of mine, for example, once raised a question about Lachmann's favorite metaphor: Lachmann often describes the world as a kaleidoscope. My friend asked him; "If the world is kaleidoscopic, who turns the kaleidoscope?" Lachmann turned to my friend, smiling, and simply replied, "That's a good question—who do you think?" At eighty plus, Lachmann continues to impact the future direction of Austrian research. He is an insightful thinker, a stimulating teacher, and a good man. There is no better tribute to a professor than that.

Peter Boettke *is acting Assistant Professor of Economics at George Mason University, and Research Associate at the Center for the Study of Market Processes at George Mason University.*