

The Role of Practical Knowledge in Market Processes: An Assessment of the Austrian Contribution

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Abstract. This paper considers the works by Austrians concerned with knowledge, especially "practical knowledge" or "inarticulate or tacit knowledge." Mainly studied are the writings of Friedrich A. Hayek who was especially influential. The paper examines the Austrian understanding of knowledge before Hayek, the contributions made by Hayek, and then the work that was done by Austrians after Hayek. Hayek's writings indicate that practical or inarticulate knowledge enables people to do things in a skillful way despite their having no conscious awareness of this knowledge unlike their awareness of scientific and propositional knowledge. Due to this realm of the knowledge, experts use the right kind of information in their work and entrepreneurs make intuitive business decisions. The Austrians point out that market processes can take advantage of this type of knowledge while central planning cannot. The author concludes by suggesting that we know little about practical knowledge and how to develop it.

JEL Classification Codes: B53, D40, D83.

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1. Introduction

There has been a revival of interest in the issue of knowledge in economics in recent years. Yet, this increasing interest rarely gives way to systematic studies of the practical nature of knowledge. Although neoclassical economics did not explicitly include "practical knowledge" into its building blocks, alternative schools of thought acknowledge its place. In schools of thought such as the Austrian, evolutionary, and realist schools we find explicit recognition of this influential aspect of human action. Among these schools, it is the Austrian school that takes practical knowledge the most seriously. Yet, the concept is a controversial one and far from being settled.

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In this paper I offer a selective discussion of how Austrian economists, especially Friedrich A. Hayek, understand practical knowledge. Since Menger almost all Austrians have seen practical knowledge as fundamental to an understanding of market processes. In fact, the issues of and about knowledge have been a central theme for the Austrian paradigm. For this reason following the traces of the Austrian understanding of practical knowledge is a difficult job.

The notion of “tacit knowing” is widely recognized in Austrian circles. I argue in this paper that the meaning of this notion is blurred. Because Hayek’s understanding of the notion has somewhat changed over time, modern Austrians tend to focus on different senses of the concept. It is my argument that two different senses of the notion create the controversy. On the one hand, some tend to understand it as the primary form of knowledge, which precedes and makes meaningful any other kind of knowing. On the other hand, there are those that tend to see it as a “qualitatively” different kind of knowing, a different realm of knowledge, which has no precedence over scientific knowledge. I believe that this point is not carefully discussed in the literature and deserves more attention.

Since practical knowledge is central to almost all Austrian themes, it is almost impossible to present a discussion by isolating its place and relation to the central tenets of the Austrian paradigm. Thus, my attempt to do that will necessarily do some injustice to the full understanding of the concept of practical knowledge in the Austrian literature.

The paper begins with a discussion of the Austrian understanding of practical knowledge before Hayek. Then, there is a discussion of Hayek’s ideas, ideas that shaped the Austrian view and led to later work after Hayek having as a central theme a practical orientation related to economic activity. The paper ends with the ideas that were developed after Hayek’s work along with a brief discussion of the questions that still remain to be answered.

2. The Austrian Understanding of Practical Knowledge: Before Hayek

Stressing the role of knowledge in economic processes has been a central theme for the Austrian school since its inception in the late nineteenth century. For Carl Menger, the founder of the Austrian school, knowledge was central to all kinds of economic activity. He emphasizes that knowledge provides a ground for the subjectivist understanding of value (Menger, 1994), and his view has become a central theme for the generations of the Austrian school following him. There are many references to practical knowledge in Menger's writings, although it is also possible to see him as a detached precursor of the neoclassical framework that denies the practical domain so vehemently. Yet, modern Austrian literature draws on a reading of Menger that views him as the founder of an alternative school of economics (Vaughn, 1994).

Menger's crucial contribution focuses on the role of knowledge in human action. Any satisfaction of human needs begins from acquiring knowledge. For him, the driving force of economic life is gaining knowledge about relevant situations. Menger's emphasis on time and the limits of human knowledge also bring up the issue of learning and its place in economic life. "In so far as men recognize their ignorance and try to overcome it, they must engage in some learning process and take some actions that lead to a future different from the past" (Vaughn, 1994: 24).

As for an explicit discussion of practical knowledge in Menger, it is not found; however, support for practical knowledge is found in his notion of "spontaneous order." A widely cited question asked by Menger, the question his theory of organic social change tries to find an answer to, is "how can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a common will directed toward establishing them?" (1985: 146) His answer to this question relies on the unintended consequences he sees of individuals who follow their own self-interest. In his view an unintended consequence of the

differences among individuals' subjective evaluations is that they provide the ground for a stable order.

Regarding this order, take his famous discussion on the origins of money (Menger, 1994, ch. 8). In his discussion he points out that individuals do not always get what they exactly want using the barter system. It is both costly and time-consuming to find the exact match. Thus, they tend to exchange their goods with more marketable ones. This process eventually singles out one commodity, a commodity that becomes "money." The desire to have smoother ways of trading for the sake of personal goals motivates market participants. They do not "purposefully" think about or discuss the advantages of a commonly "understood" or used "money." In this instance, Menger appreciates the role of local knowledge even though he does not emphasize tacit knowledge in his writings. In this case, individuals make "maximal" decisions that include local knowledge. Their use of "money" is a spontaneous outcome of the market process. In other words, they do not invent "money." It is an "unintended" result of their self-oriented activities. It is also the use of local knowledge that aids people in finding better ways of carrying out transactions (Menger, 1994: 261). In brief, a spontaneous order comes to exist out of the self-interested actions of individuals. This order is not designed by any of those individuals or by a higher authority. Furthermore, Menger's emphasis on the role of knowledge, ignorance, and error in economic activity reveals that different situations create different perceptions and expectations. These provide the first signs of a practical understanding of the market process in the wide sense of "practical."

Other issues relevant to knowledge became a central part of Austrian economics during Mises's debates with socialists (Lavoie, 1985). In many of his writings, Mises argues that private property and market processes are the only mechanisms that make the necessary information for decision-making available to individuals. In the absence of private property no rational decision-making is possible because of the absence of economic calculation. It was Mises's discussion of economic calculation that became the source of Hayek's theory of knowledge.

Comment: A brief discussion of Bohm-bawerk and Wieser.

- the role of meaning and understanding
- the debate over natural sciences vs. human sciences.
- they were against positivistic tendencies

The socialist alternative assumes the full availability and equality of technological and economic knowledge. With these assumptions, socialists argue that individuals no longer need to make “economic” decisions. The tacit dimension shows itself most clearly in these “economic” decisions. However, although technological knowledge, in one way or another, may be available for production, individuals will still need to decide on whether they should act on it or not. This economic decision-making process is possible only in the market context. In Mises’s words, “Monetary calculation is entirely inapplicable and useless for any consideration which does not look at things from the point of view of individuals” (1949: 230). Entrepreneurs, for example, weigh alternatives using their skills, abilities, capabilities, resources, and so on. Moreover, they do it in a practical setting, in the everyday world.

In this paper I mostly focus on Hayek’s work. This is mainly because of Hayek’s crucial place in the Austrian understanding of practical knowledge. It was Hayek who explicitly discussed the fundamental place of knowledge in market processes. Furthermore, his important contribution in describing competition as a discovery procedure brings his arguments to the forefront.

3. The Austrian Concept of Practical Knowledge: Hayek’s Contribution

In this section, step by step in chronological order, I will try to show Hayek’s understanding of practical knowledge. I will be emphasizing the definitions of tacit and local knowledge and how Hayek treats them. With the help of phenomenological insights, I will try to clarify some of the issues related to practical knowledge that Hayek left in the dark.

Playing an important role in Hayek’s thinking is “inarticulate knowledge.” It was a subject discussed in his early writings on the role of knowledge in economic processes. A reference to inarticulate knowledge as well as “local knowledge” is found in his 1935 essay

“Socialist Calculation II: The State of the Debate” (1948c). In this essay he argues that no single person has all of the knowledge that is used in economic calculation in his head at any one time. Moreover, this knowledge includes the practical ability to do things. He writes as follows: “Much of the knowledge that is actually utilized is by no means ‘in existence’ in this ready-made form. Most of it consists in a *technique of thought* which enables the individual engineer to find new solutions rapidly as soon as he is confronted with new constellations of circumstances” (1948c: 155, italics added). As this quotation indicates, Hayek considers practical knowledge a different realm of knowledge. A central authority cannot use this kind of knowledge. It is in the world of each individual in the market and remains there. While we may debate over what Hayek meant exactly by “technique of thought,” it certainly refers to some kind of inarticulate structure of knowing or ability. This can be seen from Hayek’s stress on each individual finding solutions, “rapidly as soon as he is confronted” with a problem. Surely, the discovery of a solution is due to accumulated skills and experience.

Hayek in his “Economics and Knowledge” essay (1948b) argues that practical knowledge is crucial in disequilibrium situations. Indeed, this work brings up a new understanding of what economics is all about. Hayek claims that the dissemination of knowledge is what is central to economic phenomena rather than the pure logic of choice. His conception of “relevant knowledge” refers to the implicit practical know-how of individuals (1948b: 51). This provides the ground for the achievement of spontaneous order. Through the use of practical and relevant knowledge that includes “skills” as well, it becomes possible to reach equilibrium through disequilibrium processes. The spontaneous interactions of people in society make adapting to change possible. This kind of knowledge is local in its essence rather than “tacit.” Although Hayek offers a discussion of skills in a footnote (1948b: 51), he does not expand on it.

In his 1945 paper, “The Use of Knowledge in Society” (1948a), Hayek explicitly discusses “the knowledge of the particular circumstances of time and place.” This essay, one of the most widely read works of Hayek, has a simple goal. It shows us that the success of the market comes from its effectiveness in bringing into use

private and local knowledge as opposed to scientific and propositional knowledge.² The efficient use of the details of everyday economic life, or the knowledge of “the man on the street” makes the market system superior to any kind of planned system. This local knowledge does not necessarily have the connotation of “knowing one’s way around” which is valid for *all knowers*. In this essay, Hayek explicitly argues that much of economic knowledge is embedded in practices, shared skills, institutions, and habits. Existing knowledge, thus, is not limited to only the “data” we find in statistical annuals.

Hayek further develops the subjects of local and inarticulate knowledge in his book, *The Sensory Order* (1952). Here he explicitly states that “what we experience consciously as qualitative attributes of the external events is determined by relations of which we are not consciously aware but which are implicit in these qualitative distinctions, in the sense that they affect all that we do in response to these experiences” (1952: 167). As this passage implies, our ability to know the external world is the result of some kind of tacit understanding of how the world works.

Hayek moves from an implicit understanding of the role of “tacit knowledge,” as seen in his early writings, to the explicit use of “tacit knowing” and “knowing-how” in his book, *Constitution of Liberty* (1960).³ Here, he focuses on the important role of “ignorance” in the

²Hayek’s increasing emphasis on tacit knowing and practical and skillful coping becomes evident in his quotation from Alfred Whitehead: “It is a profoundly erroneous truism, repeated by all copy-books and by eminent people when they are making speeches, that we should cultivate the habit of thinking what we are doing. The precise opposite is the case. Civilization advances by extending the number of important operations which we can perform without thinking about them” (1948a: 88). However, in this essay we do not yet see an explicit discussion of tacit knowledge. Hayek talks about local knowledge or “the special knowledge of circumstances of the fleeting moment not known to others.”

³Some call this the beginning of “Hayek IIP” where they see a certain shift in Hayek’s thinking. Hayek I comprises the period up to 1936. Hayek II includes the

advancement of civilization. Man can act by means of knowledge he is not aware of. Hayek writes that “the knowledge which any individual mind consciously manipulates is only a small part of the knowledge which at any one time contributes to the success of his action” (1960: 24). In other words, even when we accomplish a simple activity, we use a huge amount of knowledge that remains in the background. As the quotation above hints at, Hayek’s reference to inarticulate knowledge suggests that it constitutes a different realm of knowledge.⁴ It means that there is a “kind” of knowledge that we cannot articulate or even know that we possess but that we make use of. Thus, we aren’t aware of the whole of knowledge that is necessary in order to do things (1960:27). Not only do we have the realm of propositional knowledge, for example, we have this other realm of knowledge. A good example of this realm is the knowledge of experts. As Hayek reminds us, what makes an expert is not their substantive and scientific knowledge. It is rather their practical knowledge that allows them to skillfully use the right kind of information (1960: 25). Later on in his 1962 paper (Hayek, 1967) and in his book, *Law, Legislation and Liberty* (1973), Hayek makes the central point of his discussion the distinction between inarticulate knowledge and propositional knowledge .

The most explicit discussion of practical knowledge is in Hayek’s essay “Rules, Perception and Intelligibility.” In this essay, he defines “know-how” in the following way: “Know-how’ constitutes the capacity to act according to rules that we may be able to discover but that we need not be able to state in order to obey them” (Hayek, 1967: 44). Here, Hayek is discussing a “tacit” dimension that includes phenomena that people know how to deal with even though they don’t know exactly what they are doing. In the

years from 1936 to 1960. The change in the central themes of Hayek’s work determines the boundaries of this tripartite structure (Fleetwood, 1995).

⁴Know-how in the sense of being -at-home with something is with us all the time. This practical understanding is *existential* because it shapes our way of existing. Through it we know our way around in the world and define ourselves (Grondin, 1994). Apparently, this is not what Hayek meant in this work.

case of skills we are not able to state explicitly how we are acting. Children and many adults, for example, can speak their native language well without any real knowledge of the grammar of their language. They can even correct the errors of other speakers. This leads Hayek to ask why people are able to follow social rules without knowing anything about the rules they are following. In addition, with inarticulate rules we not only follow the rules, but they shape our perception of other people's actions. This means that the way we see the world is also rule-governed. Having a tacit understanding of rules, we can see what it means to follow a rule, and notice, intuitively or instinctively, when we see an irregular act. Toward the end of this essay Hayek asks whether inarticulate rules always guide our mental activity. If this is so, it shows the limitation of explicit knowledge in understanding the world. He argues that if we understand others because we share with them some unexplained common rules, it can be concluded that we always know more than we can say. Since what we explicitly state is based on some presumed rules of conduct, any attempt to formalize these rules will necessarily presuppose a higher level of rules. This creates an infinite regress in explicitly stating the workings of the world. As this discussion shows, articulated knowledge is meaningful against the background of inarticulate knowledge. Hayek, thus, brings to our attention another dimension of tacit knowing. Polanyi states the matter as follows: "All knowledge is either tacit or embedded in tacit knowing."

In Hayek's late addendum (1978) to his early essays on knowledge and competition, an explicit discussion of local knowledge in the context of entrepreneurial discovery is presented. For him, economic competition "is a method of discovering particular facts relevant to the achievement of specific, temporary purposes." He later explains what he means by this kind of knowledge (1978: 182): "The knowledge of which I speak consists rather of a capacity to find out particular circumstances, which becomes effective only if possessors of this knowledge are informed by the market which kinds of things or services are wanted, and how urgently they are wanted." The capacity to find out particular circumstances requires a unique combination of individual knowledge and skills. This capacity remains tacit most of the time (1978: 182). Apart from this brief

allusion to tacit knowledge, Hayek does not refer to it in this influential paper. He takes it as an instrumental factor in the background and does not bring it to the forefront the way he did in 1973, the year he published *Law, Legislation and Liberty*, where he distinguished orders and organizations in terms of the role of tacit knowing in their structure. In his last work, *Fatal Conceit*, he again discusses tacit knowledge directly. Here he writes (1988: 78), "There is a difference between following rules of conduct, on the one hand, and knowledge about something, on the other . . . The habit of following rules of conduct is an ability utterly different from the knowledge that one's actions will have certain kinds of effects." Another clarification comes some pages later (Hayek, 1988: 89), "So much knowledge of particular circumstances is unarticulated, and hardly even articulable (for example, an entrepreneur's hunch that a new product might be successful) that it would prove impossible to make it public quite apart from considerations of motivation."

In the end, Fleetwood's insightful work (1995) on Hayek supports the thesis that Hayek refers to two different kinds of practical knowledge in his early economic writings and in his later more philosophical works. On the one hand, Hayek refers to non-tacit local knowledge, which is not primary. This is the local knowledge that an entrepreneur, for example, has about some particular market. We may easily describe this kind of knowledge as articulate and, in principle, propositional. On the other hand, we have tacit knowledge, practical knowing how to do certain things. An entrepreneur's experience-based understanding of what distinguishes a profit opportunity from mere price differences is a good example of this kind of knowledge.

Yet, it is a controversial issue among Hayek scholars as to whether Hayek understands practical knowledge to be primary knowledge. John Gray (1988: 59), for example, sees Hayek's understanding of practical knowledge as a "version" of the thesis of the primacy of practice as we see in the works of Wittgenstein, Heidegger, Ryle, and others. Lavoie (1985, 1995) and Sabooglu and Langlois (2001) also support this interpretation. They dub Hayek's tacit knowledge the primary form of knowledge. On the other hand, mainstream Austrians tend to interpret it as a different realm of

knowledge, and although most of the Austrian literature refers to Hayek's discussion of tacit knowledge, we do not see any important clarification of the issue coming from this body of work. Recently, however, O'Driscoll and Rizzo (1996: 104-5) have presented their own description of tacit knowledge. In their standard textbook rendition, they discuss tacit knowing as another realm of knowledge. Tacit knowledge to them refers to a "non-deductive and non-scientific" kind of economic knowledge. It is knowledge that either one does not know one has or does not know how to articulate. It is understood to be the counterpart of scientific knowledge. They argue that much of economic knowledge remains tacit and private. This kind of knowledge cannot (or does not) get articulated. The reason is that it may take too much time to articulate. Moreover, conveying one's "intuitions" is not easy. Thus, they conclude that some part of knowledge remains tacit all the time (O'Driscoll and Rizzo, 1996: 104-5). This reading of tacit knowing implicitly assumes that it is not essentially primary. It is about a *qualitatively* different kind of knowledge. Apparently, Fleetwood (1995: 97) also adopts this second interpretation. Some interpreters even tend to downplay the role of tacit knowledge in Hayek's system. The foremost example is Victor Vanberg (e.g., 1991, 1992). In addition, the attempt to find "rationalism" in later Hayek does not leave much room in favor of tacit knowing.

In sum, what we see in Hayek is an awareness of inarticulate and tacit knowledge even in his early writings. Yet, because of the lack of a theoretical structure to analyze this theme in those writings, Hayek was not able to deepen his work in that direction. As he moved to philosophy, he began to use the insights of phenomenology and gestalt psychology. This provided him with a framework to locate his insights on the primacy of practice and the mode of formal and scientific knowledge into a theoretical framework. Though he recognized the inarticulate dimension of all articulated knowledge, Hayek did not go further in this direction. However, it is reasonable to argue that with Hayek's work, the primacy of practical knowledge and the impossibility of conveying it to a central planner have become central tenets of market process theory.

4. Extensions and Applications of Practical Knowledge: After Hayek

Modern Austrian economics follows the paths of Kirzner and Lachmann. While Kirzner's work tends to be understood as the middle ground between the neoclassical framework and radical subjectivism, Lachmann has been influential in shaping the core of the radical subjectivist wing. The role of practical knowledge has received relatively more attention within Lachmann's framework.

As a distinguished member of the radical subjectivist Austrians, Lachmann gives special emphasis to the issue of knowledge. While we see the important place of "practical knowledge" in Lachmann's work over-all, it is not explicitly discussed in most of his writings. In his work, the issues of knowledge and time come to the forefront within a Shacklean framework. He discusses future knowledge. Because it is in the range of radical uncertainty, there are no tools to deal with it. Yet, this does not stop individuals from imagining it (Lachmann, 1994b: 236). Conjecturing related to the future is about "expectations." Each and every individual imagines a future arising from his circumstances. In Lachmann's words, "Divergent expectations are nothing but the individual images, rather blurred, in which new knowledge is reflected, before its actual arrival, in a thousand different mirrors of various shapes" (1994b: 237).

Lachmann's understanding of knowledge provides important support for tacit and local knowledge. For him, knowledge is always changing, so we cannot know whether we have identified it correctly. Indeed, it does not allow objectification through identifying its nature due to the passing of time. These interrelations become the central characteristics of the market process for Lachmann. As he writes, "The market process is the outward manifestation of an unending stream of knowledge" (Lachmann, 1976: 127).

When individuals face new situations and come across people with different levels of skills, changes occur in their understanding of relevant knowledge. This is practical knowledge specific to

particular times and circumstances. Lachmann points out that "know-how" creates different kinds of actions, "Even where different actors possess identical knowledge about the same objects, they will not make the same use of it, as such knowledge exists for each of them within a different frame of relevance" (1994a: 220).

Lachmann goes on to argue that knowledge is not to be copied but interpreted (1971). This brings up the issue of the nature of knowledge and the need to discuss the more active orientation of human knowledge. Human activity is contextually situated which creates different responses to changes in economic phenomena. The tacit component plays a crucial role here.

O'Driscoll and Rizzo, in their widely read book, discuss tacit knowing, as stated above, as another realm of knowledge that they see as a "non-deductive and non-scientific" kind of economic knowledge (1996: 104). It is also knowledge that either one does not know one has or does not know how to articulate. They offer two reasons for why tacit knowledge remains inarticulate. Firstly, it may take too much time to articulate. When an entrepreneur has a specific tacit understanding of a situation, other market participants may not easily understand the particular situation. In addition, the "cost" of articulating or trying to communicate what is understood may be prohibitive. Secondly, in the case of decision-making, for example, based on "intuitions," the intuitive dimension probably cannot be conveyed to other people completely. Some part of it remains tacit all the time (O'Driscoll and Rizzo, 1996: 104-5).

This view of tacit knowing implicitly accepts that it is not essentially primary. Rather it is a qualitatively different kind of knowledge. My contention is that the phenomenological interpretation is correct and that "primary knowledge" is different from "tacit knowledge." To put it differently, "intuitive" decision-making, for example, also relies on primary understanding.

Lavoie is another modern Austrian thinker. He has ardently defended the distinction between "knowing-how" and "knowing-that." His re-interpretation of the socialist economic calculation

debate, with the help of Polanyi's work, has brought new support to the Austrian argument against central planning. For Lavoie, the strength of the Austrian view comes from its emphasis on tacit knowledge that is best used through a market process (1985a).

Lavoie in his work on the role of tacit knowing in the market process (1985b; 1995) argues that the market process makes use of inarticulate knowledge more "efficiently" than central planning does. Central planning by its nature cannot find ways to utilize tacit knowledge.

In his later work, Lavoie has turned to a more philosophically oriented discussion that deals with understanding everyday experiences. By following the traces of philosophical hermeneutics, he argues for a more historically informed understanding of human action. His argument can be seen as a philosophical reorientation of the themes in his interpretation of the economic calculation debate. In addition to emphasizing the tacit dimension of judgment and imagination, he argues for a dynamic process of understanding (Lavoie, 1987: 584). In this process, interpretation is possible because we already have an implicit pre-understanding of the situation. For him, the meaning of human action originates from a primary familiarity with the world. This pre-understanding is the basis of all knowledge. Interpretation makes understanding explicit and brings it to the fore. Thus, all human activities, including scientific activities, are interpretive in the sense that they begin with an already understood world. In this way, Lavoie criticizes the orientation of Schutzian Austrian theory for giving way to the formalization of economic activity (Lavoie, 1991).

5. Open Questions

This paper has had a simple goal. It is to understand the Austrian conception of practical knowledge. As presented here, it is a different realm of knowledge like scientific knowledge. It precedes other kinds of knowledge of the world. I turned mainly to Hayek in this paper since his work has shaped the way Austrians understand

practical knowledge. Studying his work also seemed to be the best way to separate different meanings of the concept. I tried to show that Hayek came to see practical knowledge as primary only gradually. Even now, many Austrians do not accept the idea that practical knowledge is primary knowledge. Although I did not have time in this paper to discuss the possible implications of this distinction, it is easy to see that it changes the way we understand the world a lot. To give one example, thinking about the way we learn would change. If we view learning as a practical matter, important questions about the rational processes of learning would arise. More fundamentally, we may begin to see human action as skillful and concerned coping rather than as rational decision-making. As this paper has tried to indicate, it is through practical knowledge that we find our way in the world. It encompasses all aspects of our everyday coping. Thus, every human action begins in the everyday world.

When we realize that tacit knowing is crucial for the market process, we face a variety of questions. How do individuals come to know how to get along with the things that they face in their everyday world? How do entrepreneurs learn to see opportunities, and what makes them act upon them? How does tacit knowing shape the nature of explicit statements about market "facts"? These questions still beg convincing answers.

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