Austrian Economics In Contemporary Business Applications

6 Professors build a robust bridge from economics to innovative new business models.

E4B Economics For Business

Think Better, Think Austrian

INTRODUCTION

Economics for Business is a project to apply the insights of Austrian economics to the business discipline.

Business school instructors and business writers tend to view firms through the lenses of engineering and math. Firms and strategies are like engines or machines, to be designed and constructed and tuned. They operate on external variables like markets or structures like industries. Strategies are black boxes attached to the engines to boost performance.

Austrian economics brings a new perspective and a new approach to thinking about starting, growing and managing firms.

Principles of Austrian economics, including, but not limited to, subjective value, consumer sovereignty, entrepreneurship, time preference, and capital theory open up pathways for innovative business thinking. These pathways penetrate strategy, finance, marketing, organizational design, and the broad swath of business management.

Very importantly, Austrian economics is a science of human behavior. Customers, entrepreneurs, managers, and employees are seen as people, and not as automatons or data series. Empathy is a core business skill. The purpose of business is to improve lives.

We believe the Economics for Business project has the potential for **current educators** (professors, business school instructors and others) to identify a path for themselves as online instructors, course content producers, thought leaders, and valued experts in the **new field of Austrian Economics for Business.**

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Think Better, Think Austrian

PREFACE

Professor Peter Klein observes that "The Austrian school is best-known for its fundamental contribution to economic theory. But Austrian economics is also eminently practical, with a wide range of applications to practical management problems".

This insight eventually developed into a project we call Economics For Business, a project to greatly expand the awareness of Austrian economics and the appreciation of the applicability of its theories and principles to business teaching and business consulting.

The business discipline — business as taught in business school and at universities, and written about in business books — has inherited the same errors of positivism as has economics and psychology. All variables are viewed as measurable, and so can be mathematicized and isolated in experiments. People are automatons and their behavior can be motivated and manipulated. There is a positivist agenda and a deterministic paradigm, and the goal is to predict.

Austrianism offers a totally different paradigm, with the aim to understand rather than to predict. We can offer concepts of how we think the world works, and these concepts are studiable. There is plenty of room for empirical data, but the conclusions are softer (as opposed to "this is true"), tending towards indications of how to continuously and dynamically adapt to changes, and towards improved chances of better serving customers by better understanding them.

Such a change in the science of business would be a Kuhnian paradigm shift. There is no shortage of building blocks from which we can construct a new science of business.

Customer Sovereignty

The proper terminology in Austrian economics is consumer sovereignty, indicating the power exerted by consumers over the production process by buying or not buying. In Service Science, the branch of the business discipline that studies service systems of production and delivery and feedback (as opposed to manufacturing and physical goods), the term for the end -user is always customer, whether the service is B2C or B2B. We can adopt the customer terminology because the principles of empathic diagnosis to identify and understand wants and needs is applicable to consumers of economic goods as well as customers of business services.

As a result of seeing through the lens of customer sovereignty and deducing customer motivations and preferences through empathic diagnosis, Austrian economics brings a revolutionary approach to business strategy, and new meaning to the concept of customer centricity. A business concept like Agile, which purports to place the customer at the earliest possible position in the stages of production, is given new clarity.

Subjective Value

The purpose of business is to create and keep customers, according to Peter Drucker (who, incidentally, is Austrian by birth and met economists like Ludwig von Mises and Joseph Schumpeter at the family dinner table in Vienna). Drucker's proposed primary route is the creation of value through innovation and marketing.

> *The purpose of business is to create and keep customers.*

Austrian economists know about and understand value better than anyone else in the business discipline. Value is subjective — an experience that takes place entirely in the customer domain. Logically, no external force can create it or even co-create it. Only those who ultimately consume can create value. Value is not "created" by firms.

This insight places Austrian economists in the unique position of redefining value for business practitioners and redefining the purpose and processes of the firm.

Entrepreneurial Judgment

Austrian economics identifies the entrepreneur as the driver of the market system. Entrepreneurship is the process of identifying unmet customer needs, imagining a new solution to meet those needs, assembling the resources to activate the new solution and offering a value proposition to the customer.

This process is conducted in uncertainty — there is value uncertainty on the part of the customer, who can't possibly know if a future value experience will be satisfactory, and on the part of the producer, who can't possibly know whether the value proposition will be well-received.

Entrepreneurial judgment cuts through uncertainty as an act of will. The entrepreneur seeks to reduce the magnitude of the uncertainty — an effort with which Austrian economists are best placed to help — but nevertheless must ultimately act in its continued presence and assess the outcome of the action.

Austrian economists have studied entrepreneurial judgment, including how it is delegated and distributed in firms and economic ecosystems. We therefore have much to say about innovation, organizational design, partnerships, contractual arrangements, and all the aspects of business where acting under uncertainty is the norm.

Capital Allocation

Austrian Capital Theory is the best intellectual tool for the allocation of scarce capital in the context of the firm. It can be utilized to identify those parts of the capital stock that generate the highest return in terms of revenue from customers. Often this is a small percentage of a firm's capital — much of the rest is essentially overhead or cost — and the clarity of Austrian analysis is particularly helpful to businesspeople.

Austrian Capital Theory also points the way to a required flexibility in the capital structure of the firm — it should rapidly reflect changes in the market data — and suggests highly contemporary approaches to capital where "fixed" is replaced by "flexible" in new-to-the-world supply chain (or supply network) arrangements.

Application to the Business Discipline

Three examples of elements of the business discipline that Austrianism would change in this paradigm shift are marketing, organizational design, and business strategy.

Marketing

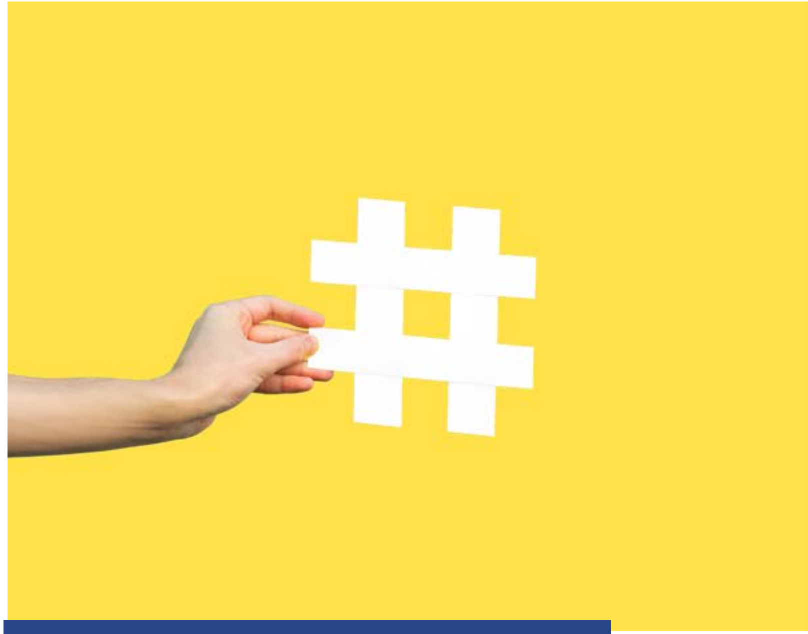
This is the business discipline that is closest to subjective value and has made strides towards Austrianism with concepts such as service-dominant logic (which Hanken School scholars have advanced to customer-dominant logic and Austrians can advance further to value-dominant logic).

However, marketing today is in the grip of so-called behavioral economics to explain consumer behavior (as opposed to Austrian subjective value). Behavioral econ suffers from the aim to predict and to manipulate consumer behavior based on the results of experimental findings.

An Austrian approach to marketing would focus on understanding consumer ends and desires, and on facilitating their experience (as opposed to, for example, "persuading" them to buy). Facilitation might result in consumers re-ordering their preferences as an emergent result of two-way interaction with them.

Marketing's role is both to help the consumer to learn (the Value Learning Process) and to learn from them in return. The marketing goal is to understand what the consumer's life is like, and to learn how to fit in to it and contribute to better experiences.

Marketing would not be a function or a department in a firm, but an integrated understanding within all part of a firm's structure, especially those that have interaction with customers.



"An Austrian approach to marketing would focus on understanding consumer ends and desires, and on facilitating their experience (as opposed to, for example, "persuading" them to buy)."

Empathic accuracy would be marketing's currency. Design and communication would follow.

Organizational Design

Austrians are already major contributors to organizational design thinking, mostly on subjects regarding the best alignment of incentives, the structure of hierarchy versus network, and the role of judgment, both original and derived.

An Austrian organizational design paradigm would focus on the value proposition and how to deliver it. Since value propositions should be unique, then organizational designs are not replicable.

An Austrian theory of organizational design would focus on how to bring markets into the interior of the organization, and on the (subjective) individual motivations of employees.

How can those ends be aligned with those of the organization's owners? How can the firm best hire people with aligned ends? How can the firm align with individuals' purpose in their work, and help them see and understand how the firm's purpose fits them? How can organizational design best be matched to the firm's mission and business model?

The firm is a facilitator of value for its "members" (customers and employees) but not "stakeholders" (e.g. shareholders, environmental activists).

Business Strategy

Austrianism is probably viewed as closest to the Resource Based View (RBV) of strategy at the firm level, but this view may need rescuing, at best, or replacing.

In RBV, resources are said to have value — meaning in the objective sense, assessed by VRIO (Value, Rarity, Imitability, Organization). An Austrian view would see resources subjectively: resources are a concept. Resources can not constitute a "competitive advantage".

The only competitive advantage is that consumers prefer one value proposition to another at one point in time.

Similarly, strategic frameworks like Porter's 5 Forces and P&G's Where To Play And How To Win have no place in Austrianism. The idea of an "industry" (core to Porter's model) is a made-up concept without validity.

A breakthrough for Austrianism would be to develop a toolset that consultants could use to help clients (which is at the core of what we are trying to do with the E4B project).

Summary

We envisage a “movement” among the Austrian community to pursue this Austrianization of the business discipline. In addition to advancing Austrian economics, it would provide productive pathways for young Austrian economists in business schools, consultancies and business in general.

In this collection, we present the individual thoughts — and some personal experiences — of six professors on the general subject of the application of Austrian economics to business. Our purpose is to stimulate enthusiasm among the broad base of Austrian economists and Austrian-friendly and Austrian-aligned business thinkers.

We are building the knowledge management capability of the Economics for Business project. This will include content, teaching (in the form of online courses), tools, forums, experience sharing and mentoring. We hope to encourage the community of Austrian economists to contribute, and make a name for themselves in the newly shifted business discipline paradigm.

Please feel free to contact any one of the contributors whose works are featured in this book, or register at mises.org/e4b-creators to learn more about the Economics for Business project.

CHAPTER 1

THE POWER OF AUSTRIAN SUBJECTIVISM

Steven E. Phelan, Distinguished Professor of Entrepreneurship at Fayetteville State University

I have been an academic for over 25 years. But before ascending to the ivory tower, I worked for several years at large corporations in strategy and finance. Both strategy and finance deal with the future.

One of my jobs involved managing the financial projections for the first optical fiber network in Australia. Another, the purchase and disposition of jets for Australia's largest private airline. Both projects required heroic assumptions about revenue, expenses, and capital investment for 20+ years into the future.

In fact, capital budgeting techniques take for granted that you can project the risk-adjusted cashflows for a project in perpetuity, consider the incremental effects of different scenarios, and select the course of action that will maximize discounted expected cash flow.

The logic is impeccable, the math exquisite — as long as the assumptions hold.

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The problem, particularly with the optical fiber network, was that the numbers didn't work. In every scenario that used realistic inputs, the value of the project was negative. As a quant — a non-business major with a penchant for numbers — I thought this was quaint, but I had no idea what I was doing wrong. In the end, I was able to torture the numbers to produce a positive return and the network was built.

In truth, it was going to be built anyway, but the 'good' numbers were still needed for some sort of totemic reassurance. Much later, I discovered something called real options theory, and realized I'd been leaving out a great deal of value in my project, enough to easily make the project feasible. But calculating the option value of the project required even more math and heroic assumptions. Early in my career, I would channel this frustration into a 1997 paper titled 'The illusion of certainty in capital budgeting'.

At the heart of the math, is an assumption that we know the distribution of future cashflows. In financial markets, these distributions are estimated with historical data. But what if there is no history?

As the first optical fiber network, we had no precedent for how customers would react. Our research team proved helpful, supplying us with different diffusion curves for earlier technologies, but choosing the right curve was an art, not a science.

My paper commented on the need to complement quantitative analysis with qualitative judgment, not realizing I had just re-discovered what Ludwig von Mises had been telling us almost fifty years earlier!

One little anecdote that illustrates this point is a time when several managers were debating whether to install optical fiber into new housing developments.

This was the tipping point for the technology and copper was still cheaper than fiber. The engineers were instructed to lay copper wires to maximize profit.

Several years later, the same senior managers were bemoaning the fact that they would have to replace all the copper wire with fiber at great expense. “Never mind”, said the senior engineer, “we installed fiber anyway, because we thought the previous decision was so stupid!”

Arguably, the engineers were able to see value beyond the immediate costs and acted accordingly (albeit insubordinately).

Austrian economics provides several salutary lessons for business technocrats (aka MBA students). For much of their program, they are taught the machinery of analysis, as if assumptions were certainties rather than approximations.

Jay Barney, a well-known scholar of strategic management, used to argue that the key contribution of entrepreneurship to business schools was exposing students to the ‘management of uncertainty’.

A similar claim could be made about Austrian economics. Exposing students to Austrian ideas about the market process reminds them that the numbers in the Harvard case studies they routinely crunch are not givens, but rather the subjective impressions of some analyst or decision maker.

As such, competition is a discovery process that tests the relative strength of each player’s beliefs about the future.

Each owner must make a (subjective) judgment about how the future will unfold and deploy resources according to that vision.

The more uncertain the future, the more hedging is required to mitigate against unforeseen events.

Flexibility becomes valuable, certainty is a liability. From this insight flows the advice to startups to experiment with bold conjectures but not risk more than can be lost.

The advice is equally applicable to mature businesses seeking to innovate.

We need to encourage business students to come out from behind the numbers into the real world and discard the notion that production can be optimized via linear programming, simultaneous equations, or, god forbid, calculus.

The world is a dynamic place, much of it uncertain, and not amenable to techniques that assume regularity. Every decade, managers routinely describe their own age as more turbulent than the one before, forgetting the difficulties of a previous generation.

However, as Nassim Taleb reminds us, 'black swan' events have been an omnipresent aspect of human existence. What managers are really bemoaning is that their models don't work.

One of the biggest complaints from employers of MBA students is that they are great at solving structured problems but poor at working on unstructured problems, that is, problems where the objectives, options, and payoffs are not immediately obvious.

Teaching our students to view decisions from an Austrian perspective can only boost their ability to work on the most complex problems that managers face. In hindsight, my employer made a good decision to build an optical fiber network, even though the rationale for doing so was poor.

Ultimately, someone at the top weighed the evidence and made the call in spite of, not because of, the hard data. That was a good thing.

CHAPTER 2

TEACHING AUSTRIAN ECONOMICS THROUGH PROJECT INVESTMENT APPRAISAL

Matthew McCaffrey, Assistant Professor of Enterprise at the University of Manchester

Austrian economists stress the importance of realism in economic theory, so it should come as no surprise that the same concern figures prominently in their economics teaching as well.

In fact, Austrians' emphasis on realism is one reason their ideas have proved valuable in business schools, whereas many ideas from mainstream economics have not; like Austrian economics, management teaching and research also tend to revolve around real-world problems facing entrepreneurs and managers, so it is understandable that they would have significant common ground.

Within management education and pedagogy, entrepreneurship education in particular stresses realistic, practical, and hands-on methods. A potential example is the process of *project investment appraisal,* which can give students insight into the everyday problems of business planning, cash flow, and numerous other aspects of the entrepreneurial journey.

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And precisely because it can account for real, applied problems, project investment appraisal also offers windows into many central themes of Austrian economics, especially the theories of production and entrepreneurship.

Below I explain a number of these connections, drawing on my experience teaching a course on Investment Economics and Innovation to business students. I approach this topic specifically in light of project investments. Projects can take many forms, but in my class, the discussion focuses on founding a new enterprise or expanding an established one.

The emphasis is on investments into "real" projects like new businesses that exclude purely financial investments, though it should be noted that the principles discussed are also relevant for pricing financial assets. Furthermore, as mentioned below, real project appraisal also sheds light on some special problems facing non-traditional business organizations, especially publicly-owned or publicly-run ventures.

In what follows, *investment appraisal* refers mainly to cash flow analysis. It involves forecasting the costs and revenues of a project, evaluating the resulting cash flows using a selection of investment indicators, and subjecting the cash flows and indicators to a variety of sensitivity tests.

The relevant material tends to be covered in most investing or corporate finance textbooks. In practice, appraisal is carried out through spreadsheet modeling of the enterprise's finances over time. The purpose of this process is to decide whether a business is investible or not, and if so, under what conditions.

It can be done simply for the entrepreneur's own benefit, or as the basis of an investment pitch.

It is vital to point out that this process is uncertain and that entrepreneurs, like all human beings, are prone to error. Some events simply cannot be foreseen or forecast accurately, and project investment appraisal does not automatically create successful entrepreneurs.

Nevertheless, it is a valuable tool for business planning that can tease out many subtle implications of entrepreneurs' decisions, and it gives a more concrete shape to their plans for the business. It highlights how the process of valuation and capitalization explained in Austrian economic theory plays out in real-world enterprises, and how it can be represented in part by some commonly used financial tools.

Project investment appraisal thus helps entrepreneurs recognize some of the challenges they face, many of which can be more clearly understood by using Austrian insights into entrepreneurship and the production process.

Of course, investment appraisal is not the only context in which these kinds of points can be made to business students; however, it can be a particularly effective one, especially when students construct their own investment models and forecast their own cash flows.

This kind of assignment confronts them with a practical problem and allows them to apply a variety of Austrian economic concepts to solve it.

"Austrians' emphasis on realism is one reason their ideas have proved valuable in business schools, whereas many ideas from mainstream economics have not."

Below I explain some examples of Austrian ideas that investment appraisal can draw upon, including economic calculation, money prices, entrepreneurial judgment, value imputation, factor pricing, time preference, and the effects of intervention.

Appraisal and Economic Calculation

The theory of *economic calculation* is a vital component of Austrian economics. In a market economy, calculation is the means by which entrepreneurs choose between a vast number of potential production methods and rationally allocate resources in order to meet the most urgent needs of consumers.

It is, at its heart, a problem of entrepreneurs *appraising* future prices: entrepreneurs use *judgment* to anticipate prices in order to calculate costs and plan production in the present to satisfy consumer wants in the future, all while earning a profit. There are several connections between calculation and project investment appraisal that are worth exploring.

In a sense, project investment appraisal is simply economic calculation on a small, practical scale. Outlining the expected costs, revenues, and cash flows of a business requires a common denominator in which to express these values. That common denominator is *money prices.* Without prices, there is no way to compare the enormous array of possible combinations of factors of production used as inputs, much less compare them to outputs. A common unit is therefore a vital precondition of economic calculation.

And it is easy for students to see why these money prices are necessary: without them, a cash flow model simply becomes a massive list of apples and oranges, with no way to compare. By attaching monetary values to the factors of production, it becomes possible to estimate both their true costs and their contributions to the value of the business.

Yet there is a subtler point to be made as well: students are also quick to grasp that the prices they use in their cash flow models must *mean* something. If they are inaccurate or arbitrary, then any cost and revenue estimates based on them are useless as well. Real-world entrepreneurs cannot "play market" by inventing price data any more than central economic planning committees can.

This leads to another insight that is brought to life by investment appraisal: students can easily understand that for public projects and enterprises there are often no costs or revenues to input, or any meaningful cash flows to appraise.

For example, public enterprises may use price controls to pay artificially low prices for land, labor, and capital, or public goods may be provided at zero price at the point of consumption. These kinds of operations leave enormous gaps in any investment analysis. Of course, data can always be estimated or invented, but it is easy to see how doing so undermines the realism and the usefulness of the appraisal process.

It also hints that the projects themselves face serious calculation problems, as they have little or no way to measure their own success. Students thus see the uselessness of inventing prices to include in a cash flow model: as the old saying goes, "garbage in, garbage out." In this sense, working through a project appraisal also promotes a kind of realism that is sadly lacking in much business-school teaching.

Standard classroom exercises in environmental scanning and strategy, for instance, often give a simplistic view of the complexity and uncertainty of entrepreneurship, encouraging students to think in terms of applying basic data to find convenient, one-size-fits-all solutions to fit pre-packaged case-study problems.

In contrast, students trying to forecast using incomplete data learn quickly that project investment appraisal is a speculative and fundamentally uncertain process: it can be nearly impossible to manage, even at the small scale at which most student business ideas operate.

> *"Calculation is the means by which entrepreneurs choose between a vast number of potential production methods and rationally allocate resources in order to meet the most urgent needs of consumers."*

Although there may be reliable data available regarding current costs, prices, and other quantitative factors used in cash flow analysis, the data of the market are often unknown and constantly changing, and in entrepreneurship the only constant is uncertainty.

As a result, entrepreneurs are obliged to forecast changes in the data. Yet doing this in practice immediately reveals how limited historical market data are for planning. Entrepreneurs must appraise the *future* prices of the factors of production, which cannot be done simply by projecting past prices forward in time.

This is a key lesson for my students, and one that is made clearer using the theory of economic calculation.

Production, Imputation, and Net Present Value

This economic process gives students another way to look at project investment appraisal, in which *Net Present Value* (NPV) plays a key role. Specifically, Austrian value theory helps to show students that the appraisal process, including the use of quantitative indicators like NPV, is consumer-driven.

The unique core of Austrian economics is its theory of value, price, and distribution. Austrian theory provides a unified account of value and price that shows how consumer valuations determine the entire system of market prices.

All prices ultimately trace back to individual preferences: the factors of production, land, labor, and capital goods, possess value because they create value for the consumers of final goods. The value of final consumer goods is *imputed* to the goods used to produce them. In fact, the market price of a factor of production is simply the total income it is expected to generate over its life, discounted for time preference.

The process of anticipating the future income produced by a factor, and assigning it a present price, is called *capitalization.* The final discounted price is called Net Present Value. NPV is the present monetary value of all future cash flows, taking into account the time-value of money (applied through a discount rate).

In investing, NPV is usually calculated for a business as a whole: it is the sum of the enterprise's individual capital values.

Appraising a business requires planning which factors to combine, how to combine them, and the money cost of the combination. Cost estimates are then subtracted from revenue estimates to generate cash flows. These in turn are discounted to the present to reflect the time-preference of entrepreneurs and investors. When discounted cash flows are summed, the resulting NPV gives a valuation for the business that directly depends on entrepreneurs' expectations about the incomes that the factors will generate.

For students, it is their decisions about estimating data and prices that drive their valuations, allowing them to better appreciate the difficulty of bearing uncertainty and taking responsibility for an enterprise. The more realistic they want their analyses to be, the more they need to confront the problem of uncertainty, and embrace the difficult task of peering into the future without past data to guide them.

NPV considers entrepreneurs' judgments about the future productivity of the factors as well as their time-preferences.

The Austrian vision of the pricing process is thus already implied in this widely-used investment indicator. It only remains to help students take the final steps toward realizing that consumers are the source of all the values associated with the enterprise, and that all the prices involved reflect entrepreneurs' judgments about what consumer values will be in the future. None of the prices that entrepreneurs engage with are "given" or unchanging.

Labor Costs and Public Policy

The discussions above relate to ideas that I have intentionally introduced into my courses. The final point I would like to make, however, is based on an insight I stumbled upon accidentally. Business courses spend relatively little time discussing public policy, aside from general discussions of barriers to entry and a few related topics. Yet, perhaps unexpectedly, investment appraisal can teach valuable lessons about the damage caused by government intervention, lessons that would otherwise fall outside the scope of a course on investments or corporate finance.

The example that has stood out most to me involves minimum wage laws. In my course on investment economics, students typically create business ideas that fit their personal interests. In practice this results in projects involving bars, cafes, restaurants, yoga studios, and other labor-intensive enterprises.

It is quite common for the cash flows of these kinds of businesses to be highly sensitive to the price of labor. In order to make their projects profitable (e.g. to make them generate positive NPV), students often begin by assuming low labor costs, typically set as low as legally possible — at the current minimum wage. This is frequently the only way to make the business generate positive NPV. Students then test the sensitivity of cash flows to increases in the minimum wage.

These changes tend to have immediate and serious effects on the viability of the enterprise: what is more, students see this relationship unfold before their eyes.

It's one thing to be shown a supply and demand graph and told that minimum wage increases can destroy the viability of a business: it's quite another to see the NPV of a business disappear at the press of a button, simply by increasing the minimum wage by a dollar or two.

This also reinforces the point made above that prices are not arbitrary. In the case of wages, students learn that the price of labor cannot be set at employers' whims; it has a serious impact on the delicate finances of many businesses. And while sensitivity to labor costs does not directly imply pricing labor according to marginal productivity, it is an important first step toward it.

If students follow up the realization that wages are not set arbitrarily, it is easy to then recognize the necessity of paying wages that reflect each employee's contributions to the productive process.

Going through the exercise of project investment appraisal has taught many of my students about the harmful effects of public policy. Importantly, this insight was truly spontaneous, as it was not the goal of the course to teach anything about regulation or intervention.

Nevertheless, project investment appraisal has proved a valuable tool for doing just that, and for driving home conclusions about policy in ways that might not have been possible even in traditional economics instruction.

Summary

Although project investment appraisal is not the whole substance of entrepreneurial judgment, it can still be an effective complement to it, albeit sometimes in unexpected ways. It especially provides opportunities to teach a wide range of Austrian concepts and theories. In this discussion I have mentioned only a few.

1. Entrepreneurs need money prices to appraise future prices and estimate the present value of their businesses.

2. Prices must be based on entrepreneurs' judgments about the future state of the market, that are subject to the profit and loss test.

3. A lack of meaningful prices makes it impossible to rationally plan a business venture, a problem that is especially problematic for publicly-owned and operated enterprises.

4. When forecasting their costs, entrepreneurs try to anticipate consumer valuations, because those values ultimately determine the prices of the factors of production, and therefore the costs of the business as well as its revenues.

5. Investment indicators like NPV are only as useful as the data on which they are based; sometimes reliable data can be found through careful market research and educated guesswork, but oftentimes key information simply does not exist, or uncertainty makes it almost impossible to anticipate future changes in the data of the market.

6. The Austrian theory of entrepreneurship and imputation of consumer values to the factors of production is implied in NPV, and only needs to be teased out and explained to students.

7. Sensitivity analysis can help explain the effects of public policy, for example, the effects on NPV of increases in the minimum wage.

Recommended Reading

Interested in taking a deeper dive on this particular topic? Check out the supplemental materials below, which include some of my own published academic papers and other carefully selected texts by respected Austrians in the field.

Joseph T. Salerno. 1996. "Reply to Leland B. Yeager on "Mises and Hayek on Calculation and Knowledge." Review of Austrian Economics. 7 (2): 111-125.

Frank A. Fetter. "Desires, Choice, and Value." Available at: https://mises.org/library/frank-fetter-chapter-17-desires-choice-and-value

Frank A. Fetter. "Markets and Prices." Available at: https://mises.org/library/frank-fetter-chapter-18-markets-and-prices

Frank A. Fetter. "Cost-Prices, Product-Prices, and Profits." Available at: https://mises.org/library/frank-fetter-chapter-19-cost-prices-product-prices-and-profits

Frank A. Fetter. 1977. Capital, Interest, and Rent: Essays in the Theory of Distribution. Kansas City: Sheed, Andrews, and McMeel.

Nicolai J. Foss, Peter G. Klein, and Matthew McCaffrey. 2019. Austrian Perspectives on Entrepreneurship, Strategy, and Organization. Cambridge: Cambridge University Press.

> *"It's one thing to be shown a supply and demand graph and told that minimum wage increases can destroy the viability of a business: it's quite another to see the NPV of a business disappear at the press of a button, simply by increasing the minimum wage by a dollar or two."*

CHAPTER 3

ENTREPRENEURSHIP IS ACTION UNDER UNCERTAINTY

Peter G. Klein, Professor of Entrepreneurship at Baylor University's Hankamer School of Business

As I have noted elsewhere, the Austrian economists, going back to Carl Menger, have differed from their neoclassical economist colleagues in giving the entrepreneur the central position in the analysis of the market.

While entrepreneurship played a prominent role in economic theory from the time it emerged as a systematic discipline (Cantillon, 1755), by around World War II the entrepreneur had mostly dropped out of economics journal articles and textbooks.

As the language of economics became more formal and stylized, and economists were drawn to highly abstract concepts of markets and competition such as the model of perfectly competitive general equilibrium, it was simply too difficult to incorporate a creative, dynamic, coordinating or disruptive actor into the analysis. Microeconomics became the description of various equilibrium states (existence, stability, welfare properties), and there was nothing for an entrepreneur to do.

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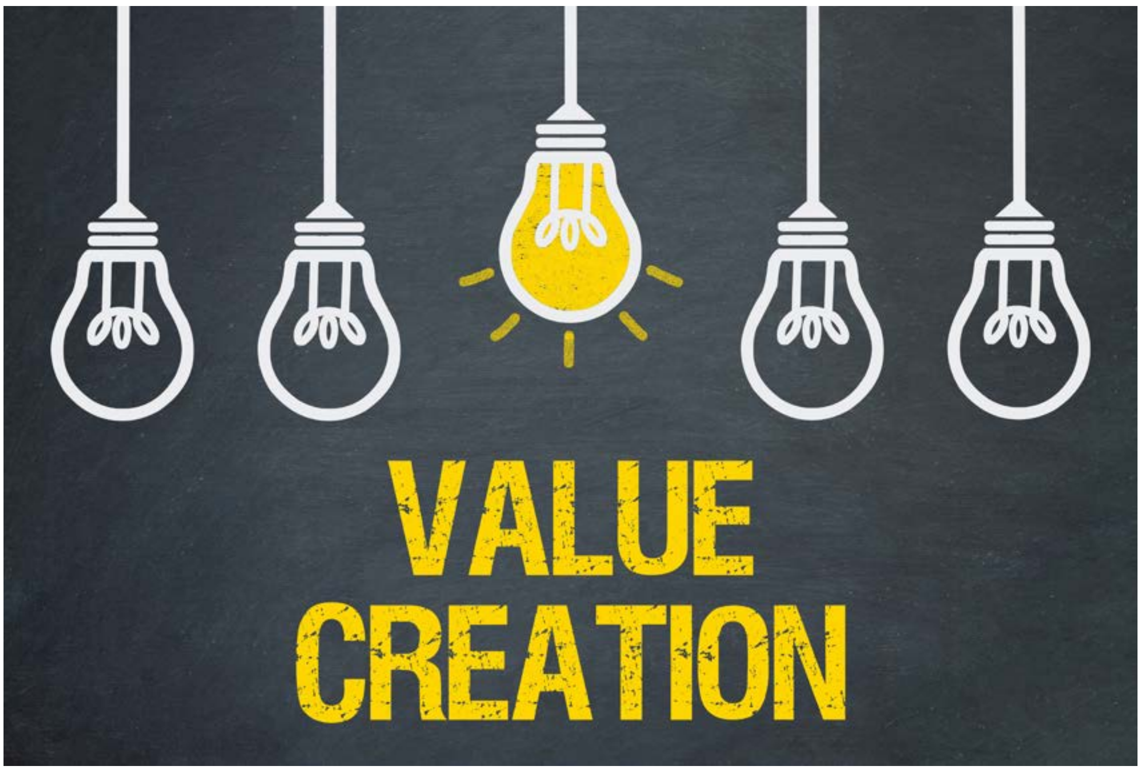
For the Austrians, by contrast, the entrepreneur as a speculator, coordinator, allocator, and innovator was always what Mises called the "driving force of the market." Note that the term "entrepreneur" to most Austrian economists does not mean self-employed person, small-business owner, or technological innovator (though all these persons can act entrepreneurially). Rather, entrepreneurship is a generalized function associated with resource allocation and value creation. For Kirzner, building on Friedrich Wieser and Hayek, that function is alertness to profit opportunities that result from prices that are not at their equilibrium values.



For Mises, Rothbard, and others such as Joseph Salerno and myself, that function involves acting under conditions of Knightian uncertainty. In either case, entrepreneurship is not uniquely associated with a particular job category (self-employment), firm type (small firm, young firm, high-growth firm), or strategy (R&D-intensive firm).

I began thinking more carefully about the entrepreneurial function while writing two papers applying Austrian economics to the theory of the firm. The second paper included a section on "Financiers as Entrepreneurs" in which I discussed David Scharfstein's argument that unregulated financial markets will not produce enough disciplinary takeovers, because shareholders in an underperforming target firm will refuse to tender their shares to a raider or acquiring firm for less than their share of the post-takeover value of the firm, leaving no profit for the acquirer.

This kind of argument, I realized, assumes that all market participants have the same beliefs about future share prices and are equally willing to bear the uncertainties associated with the restructuring process. In contrast, I saw post-takeover profits (and losses) as returns to exercising the entrepreneurial function. The analysis of firm governance could not, then, be understood without seeing financial-market participants as entrepreneurs who seek to exploit gaps in the market (à la Kirzner) or specialize in bearing fundamental uncertainties (à la Knight and Mises).

Describing business restructurings as entrepreneurial actions led me to think more systematically about entrepreneurship and to read more widely in the contemporary entrepreneurship literature. I discovered that Kirzner's concept of alertness provides the theoretical foundation for the opportunity-discovery perspective, while Knight's and Schumpeter's ideas play smaller roles.

I quickly came to the belief that the entrepreneurship literature had not read Kirzner carefully enough, and that many theoretical and applied studies (e.g., surveys asking entrepreneurs or prospective entrepreneurs to list the number of opportunities discovered, evaluated, and exploited) were inappropriately reifying the metaphor of "opportunity" used by Kirzner to explain market coordination.

Around that time Nicolai Foss and I were invited to contribute to a Festschrift in honor of Kirzner.

"For the Austrians, by contrast, the entrepreneur as a speculator, coordinator, allocator, and innovator was always what Mises called the "driving force of the market."

We assumed that most of the participants would write about entrepreneurial discovery and we wanted to do something different.

My wife, also a trained economist, reminded me that Kirzner wrote an interesting and underappreciated book on capital theory.

There Kirzner argued, building on earlier work by Ludwig Lachmann (1956), that the nature and value of an asset or resource is determined not by its objective properties (size, weight, location, construction, technical capabilities), but by its imagined place in the subjective production plans of a forward-thinking entrepreneur.

Kirzner's capital theory seemed to provide a useful means of integrating the theory of the entrepreneur and the economic theory of the firm, two bodies of literature that had developed largely in isolation, despite much overlap in approach and subject matter.

Developing and extending Kirzner's capital theory led to the Festschrift chapter (Foss et al., 2002) and two follow-up papers (Foss et al., 2007; Foss, Foss, and Klein, 2007) and, a few years later, to Foss's and my 2012 book Organizing Entrepreneurial Judgment: A New Approach to the Firm.

I usually describe my approach here as the "judgment-based view" of entrepreneurship (see Foss and Klein, 2015, for a summary and reflections). The term judgment comes from Knight, who described judgment as decision-making under uncertainty that cannot be modeled or parameterized as a set of formal decision rules. Judgment is midway between the "rational decision-making" of neoclassical economics models and blind luck or random guessing. We sometimes call it intuition, gut feeling, or understanding.

In a world of Knightian uncertainty, and heterogeneous capital resources with attributes that are subjectively perceived and unknowable ex ante, some agency must bear the responsibility of owning, controlling, deploying, and redeploying these resources in the service of consumer wants.

That, in my formulation, is the role of the entrepreneur.

The entrepreneur's job is to combine and recombine heterogeneous capital resources in pursuit of profit (and the avoidance of loss).

When the entrepreneur is successful in acquiring resources at prices below their realized marginal revenue products — i.e., when the entrepreneur exercises good judgment — she earns an economic profit. When her judgments are poor, she earns an economic loss.

Competition among entrepreneurs (and those who provide financial capital to entrepreneurs) tends to steer ownership and control of productive resources toward those entrepreneurs with better judgment.

In this model, a firm is an entrepreneur plus the alienable assets she owns and controls.

The multi-person firm includes multiple owners and/or employees who may exercise "derived judgment" on the part of the entrepreneur-owner or owners, who exercise judgment in selecting, monitoring, and delegating decision authority to these employees.

Organizational characteristics (size, vertical boundaries, diversification, ownership structure, internal organization, etc.) evolve over time as entrepreneurs experiment with different combinations of heterogeneous assets and different strategies and business models. As Lachmann put it, “We are living in a world of unexpected change; hence capital combinations . . . will be ever changing, will be dissolved and reformed. In this activity, we find the real function of the entrepreneur.”

The judgment-based approach plays a distinct role in the current conversation and controversy about the nature of entrepreneurship research. The once-dominant opportunity-discovery perspective has come under fire from a variety of perspectives. Alvarez and Barney (2007) kicked off a lively debate by challenging the ontological status of entrepreneurial opportunities, arguing that opportunities are best understood as created, subjectively, rather than existing outside of entrepreneurial action.

The judgment-based view goes a step further, arguing that the construct of opportunity itself is unnecessary at best, misleading at worst. Entrepreneurial action is seen as beginning with the entrepreneur’s interpretation of current (objective) conditions, his beliefs about possible future states of the world (e.g., a profitable product or venture), and his expectations and confidence in his ability to bring about that possible future. The entrepreneur then acts (or doesn’t act), with success or failure determined ex post, largely by objective factors.

In this formulation, there is simply no need for the opportunity construct.

The discovery view mistakenly implies that opportunities exist independent of human belief and action. The creation view rightly emphasizes human belief and action, but mistakenly implies that profit opportunities, once the entrepreneur has conceived or established them, somehow come into being. I definitely see entrepreneurship as a creative process but say that what entrepreneurs create (or attempt to create) are not opportunities, but new firms, new products, or new markets.

When they are successful, their efforts may be recast after the fact in opportunity language. But little or no additional insight is produced by doing so. Moreover, it is extremely awkward to describe entrepreneurial failure — financial loss, bankruptcy, or other forms of unintentional exit — in opportunity language. (Kirzner refers to losses as resulting from "mistaken opportunities," but wouldn't it be clearer to refer to them as the results of mistaken actions?)

I see much of my recent work as an attempt to convince entrepreneurship scholars to make action, not opportunities, the unit of analysis for entrepreneurship research, teaching, and outreach.

An action-theoretic perspective helps us (and our students and consulting clients) to remember that action always takes place under conditions of uncertainty (even for mundane activities in established industries!). The language of opportunity may also encourage overconfidence, by mistakenly conveying the idea that the results of entrepreneurial action exist ex ante, before profits and losses are realized, either because these results were there waiting to be discovered, or because the entrepreneur created them through an act of will.

> *"I definitely see entrepreneurship as a creative process but say that what entrepreneurs create (or attempt to create) are not opportunities, but new firms, new products, or new markets."*

These efforts are bearing some fruit as a judgment-based perspective on entrepreneurship is beginning to emerge, though its basic claims are often misunderstood. Much of this work has been conceptual and theoretical, though we are beginning to see applied work in entrepreneurial cognition, venture formation, and public policy.

My hope is that the judgment-based perspective will continue to grow and join the opportunity-discovery, opportunity-creation, and effectuation/bricolage approaches as a recognized alternative (though not necessarily mutually exclusive) framework for understanding entrepreneurial action and its role in the economy and in society.

> *“In a world of Knightian uncertainty, and heterogeneous capital resources with attributes that are subjectively perceived and unknowable ex ante, some agency must bear the responsibility of owning, controlling, deploying, and redeploying these resources in the service of consumer wants.*
>
> ***That, in my formulation, is the role of the entrepreneur.”***

This essay was adapted from a chapter written by Peter Klein in the book titled *The Routledge Companion to the Makers of Modern Entrepreneurship.*

CHAPTER 4

CREATIVITY, LUDWIG LACHMANN, AND RADICAL SUBJECTIVISM IN ENTREPRENEURSHIP

Vishal K. Gupta, Associate Professor in Management at University of Alabama

"What in the world is Austrian Economics?" was my reaction when I first heard about the Austrian School from a professor at University of Missouri, where I had just started the coursework for a PhD in management.

I was an engineer by academic training and an entrepreneur from work experience (by way of the family enterprise), so I had no prior formal exposure to economics.

Over the next two years, three important things happened that set me on a path I could not have imagined when I started the PhD program: (a) Jacobson's (1992) article in *Academy of Management Review* introduced a generation of researchers (including me) to Austrian-inspired research in strategic management; (b) Vaughn's (1998) book Austrian Economics in America provided a good introduction to the basics of Austrian Economics and about key figures in the Austrian school (and their ideas); and (c) Venkataraman (1997), Shane and Venkataraman (2000), and

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Hunt and Morgan (1995) cast light on how organizational scholars were using Austrian ideas to advance research in new directions.

I read voraciously in the PhD program, in part because I knew I lacked a scientific background (to be honest, I don't think most management doctoral students today are reading as much as they should, especially books and classics). I began to realize that the entrepreneurship literature at the time was focused on opportunity discovery and had largely ignored the creation of new opportunities, which I had seen happen several times in my prior life outside of academia.

Let me illustrate with an example: You have probably heard of Soda Stream, the 'once-hot device' from Israel for 'do-it-yourself' sodas, which PepsiCo bought for $3.2 billion in 2018 as part of its push towards healthier offerings. I had first seen home-carbonation machines in the 1990s in India when an entrepreneurial friend of my father had developed it for the local market, and we were among his first customers. When we bought the machine, he showed us how to use it. It was a new concept at the time, and none of our friends had anything like it then. Making soft drinks at home by mixing bubbly carbonated water with flavored and sweetened syrup was more fun and healthier than buying ready-made soda (or so we thought). For a while the business did well before other rivals came in and profit margins collapsed.

As far as I could tell, the guy had created an opportunity, invested time and effort in educating people about it, and enjoyed the fruits of his labor until the entry of new players decimated the business.

None of the entrepreneurship papers I was reading in my PhD program were really discussing such entrepreneurs and their ventures that broke new ground.

Around this time, Todd Chiles (the Missouri professor who introduced me to Austrian Economics) and I decided to write a paper emphasizing a creation view of the entrepreneurial process. In the early 2000s, entrepreneurship researchers were building on the works of Joseph Schumpeter (who I learned was considered Austrian by outsiders and quasi-Austrian at-best by those inside the Austrian school) and Israel Kirzner (a stalwart of modern Austrian thought, yet seen by some as shackled to neoclassical economics).

We decided to build on the ideas of Ludwig Lachmann, a central figure in the Austrian school, but virtually unknown outside it. Lachmann advocated that the market process driven by individuals who act based on 'undetermined creative choice' is by definition open-ended, so that equilibrium is no longer a useful tool to understand the economic system. We liked his ideas!

Writing the paper was a labor of love (requiring lots of work!) and I learned much during the process. We were emphasizing ideas that were foreign to entrepreneurship scholars at the time and calling for a radical shift towards a disequilibrating view of the market process.

An early version of the paper was presented at the 2004 Academy of Management Conference in New Orleans, where we had an audience of (only) one.

"None of the entrepreneurship papers I was reading in my PhD program were really discussing such entrepreneurs and their ventures that broke new ground."

Several unsympathetic editors, unfriendly reviews, and discouraging rejections later, the paper (in a much improved version) was published in Organization Studies, a top-tier journal headquartered in Europe.

Our novel, provocative, and iconoclastic ideas resonated with Raghu Garud from Penn State, who was the action editor for our manuscript.

His feedback was constructive and developmental, helping us sharpen the most critical aspects of our argument and jettisoning the tangential thoughts that could not be appropriately developed in the constraints of a typical journal-length paper.

Over the next several years, Todd and I - together and separately - with other scholars published several papers elaborating and extending the ideas from our original 2007 article. These papers are well-cited, some of them won awards, and all of them influenced (in some form or other) a gradual shift in the thinking of entrepreneurship scholars to include creation logic in their understanding of the entrepreneurial process.

I am currently engaged in research on managerial humility, which makes me sensitive to possible charges of ‘tooting the horn’ for my own research. In the present situation, I take solace in the fact that I am simply following the directions of the book editor Hunter Hastings who advised us to discuss “the place and promise of Austrian economics in the business school based on personal experiences.”

When I reflect on my acquaintance with Austrian ideas and the management research done in this area, it affirms to me the wide range of fertile possibilities associated with taking a creation view based on Lachmann’s work. More than a decade after the publication of our original 2007 paper, the creation view is now well-established in entrepreneurship, though theoretical development and empirical work in the area still remains at an early stage.

It is an integral part of entrepreneurship education, even as more case studies and practical tools need to be developed to help students understand the nuances of creation-oriented thinking about entrepreneurship.

There is heightened interest in the works of Lachmann, whose views used to be regarded as “outside the mainline of modern Austrian thought” (Storr, 2019: 63), but much of that conversation is taking place outside the organizational and entrepreneurship literature.

> *“More than a decade after the publication of our original 2007 paper, the creation view is now well-established in entrepreneurship, though theoretical development and empirical work in the area still remains at an early stage.”*

My hope is that, going forward, creation ideas will have an even more central role in research and teaching of not only management and entrepreneurship, but across the different disciplines of business school.

A stronger turn towards creation will probably force all of us — educators, managers, students, and administrators — to navigate some difficult and treacherous issues, but the difficulties and challenges will mostly likely be outweighed by the tremendous benefits of taking such an approach.

CHAPTER 5

TARGET AREAS FOR AUSTRIAN ADVANCEMENT

Mark Packard, Assistant Professor of Management in the College of Business at the University of Nevada, Reno

Are you an aspiring Austrian academic or, at least, considering the idea? Are you unsure of the prospects of doing research within our heterodox libertarian camp? This chapter is for you. As it turns out, social science is desperate for the insights that the Austrian school has already developed. Being an Austrian isn't a liability anymore. It's an advantage. At least, it has been for me.

My own path to academia was rather unorthodox. I was a computer engineer who found my way to the Austrian school after the 2008 housing collapse.

I was young, inexperienced, and had just bought my first house a couple of years earlier. And I had just transferred jobs and was trying to sell that house. I had no idea what was going on, having not previously had much interest in politics or economics. But now that it was really affecting me, I wanted to understand.

I went digging through all the commentaries and blog posts from economists, looking for explanations of why this was happening.

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Eventually I came across a few economists' blogs that, I felt, really understood what was happening and why. The one that most stood out to me was Café Hayek, run by Don Boudreaux and Russ Roberts. And that sent me down that rabbit hole that virtually all of us know all too well.

Fast forward a few years, I was getting a little bored with my job, and I felt I had a lot of good business ideas that I wanted to try out. But I didn't know how to start a business — they don't teach you that in engineering school. I thought maybe the fastest path to getting started might be to go back to school and get an MBA.

So I took the GMAT and applied to a few schools. I got into a few really good ones, with really good entrepreneurship programs. And as I was deciding on where to go, I talked to one of my best friends, who had gone through one of those MBA programs I was considering and was now getting a PhD. As we talked, he wondered whether I might be interested in joining his PhD program. I hadn't thought about it, but that would have to be after I first got a masters. Nope, he explained, turns out you don't have to have a masters to get into a PhD program. After a bit more persuading, I decided to apply and, somehow, got accepted very shortly afterward.

So here I was, a young Austrian PhD student at the University of Missouri. I knew Peter Klein was there, having run across his own blog in my tumble down the rabbit hole. So I quickly connected with him, took a couple of his classes, and started a research project with him and my advisor. But the problem that all PhD students face, the trick to getting an academic job, is to demonstrate a capacity to publish good research. Did I have good ideas? Could I make an impact on the field? It felt like I had a tough road and not much time to run it.

Can an Austrian make it in academia these days?

Academia is a cutthroat business. The game is 'publish or perish', and the publication opportunities are extremely limited. A surprisingly large number of PhDs never attain tenure, a vast majority of such failed cases having not met the satisfactory requirements of publishing in top academic journals. Such scholars wash out, resorting to lower-tier teaching institutions that don't care as much about research or else abandon academia and slide into the private sector.

We can't always fault the scholar for failing tenure, either. Well-known problems in the publication process include, to name a few: 'gatekeeping'—where senior scholars who developed the prevailing theories tend to be the editors or reviewers of new theories that would displace the old (the senior scholars' work) and, thus, look upon such new work with antagonism and defensiveness; ideological bias — a vast majority of academia are left-of-center and many of them far to the left, which means that (classically) liberal philosophy and research is likely to be edited and reviewed by ideologically unsympathetic peers; and hiring biases — where researchers who do similar research from similar perspectives (and, often, similar ideologies) are more likely to be hired, making it difficult for more 'radical' scholars to find jobs.

> *"Did I have good ideas? Could I make an impact on the field? It felt like I had a tough road and not much time to run it."*

Politics and ideology run rampant in academic departments, and ideologically heterodox scholars are generally forced to keep their heads down and stay quiet lest they lose their job. There has, of course, been some serious discussion toward alleviating such issues, but while these problems are well-understood, the majority of the field have little incentive to correct the problems — after all, the majority truly believe that academics favor left-wing polity because it's right.

Amid such a problematic milieu, it sometimes occurs to me that I could likely be much more successful (financially) joining the ‘washed up’ academics in the private sector. In fact, a good many academics leave voluntarily for that reason, as well as many other reasons (such as being fed up with the political ‘game’ that academia has become). But, for me, I find the scholarly pursuit so engaging and rewarding that it’s hard to want to give it up.

The rewards of success in academia are quite appealing, especially in the more highly valued fields, such as business, medicine, and engineering. Successful academics can do quite well, and the lifestyle is tough to beat.

But how can a bright young Austro-libertarian, one such as myself, find such success amid the ravenous wolves of the ivory tower?

As it turns out, at least for me, the path to success has not been in spite of but because of my Austrian philosophy and background.

The trick is, it seems, to find an area of social science that is not well explained by standard theory, but which Austrian theory much better explains. Now, if you thought ‘that’s everything’, true enough. But a lot of areas in social science, especially in economics, have theories that explain observed phenomena satisfactorily for non-Austrian scholars, and the debates are by now so tired that those mainstream non-Austrians simply shut their minds to ‘tired’ Austrian arguments. You can absolutely make it as an Austrian economist in the field of economics. But it is an uphill battle.

I was lucky enough to start my academic path interested in one of those fields that Austrians have, basically, the only good explanation for: entrepreneurship. As a result, my background knowledge in Austrian economics put me at a huge advantage rather than a severe disadvantage, relative to my peers.

I understood how entrepreneurship works better than others.

All the senior scholars in the field, and my advisor in particular, constantly advised us young scholars to pursue scholarship in the traditional way: data collection and hypothesis testing. I didn't listen. I just don't enjoy that type of research, and my Austrian roots have pushed me onto the much more difficult (for most) path of aprioristic theory-building. I know and understand the Austrian method. I know how to build theory better than most.

And it has worked for me. I have published on topics such as uncertainty, voluntarism, subjectivism, judgment, and so forth, most of it in top academic journals.

I have had several young scholars and PhD students look at my record and marvel at my successes. How did I do it, they've often asked. It's not that I'm especially ingenious or talented or anything like that.

It's because I'm an Austrian.

And I know, because of that, how to generate sound theory — a task hardly any in academia have yet figured out.

Successful Austrians in Business

While business academia, like most other fields, leans left, the profession is far more heterogenous, and thus, more open to heterodox ideas than most others. As of today, several of the most renowned scholars, especially in entrepreneurship, are in fact Austrians. In fact, the prevailing theory of entrepreneurship is quite explicitly Austrian, based almost exclusively on Israel Kirzner's classic work.

Many others are not Austrians but are sympathetic to the school of thought and are, at least, ideologically aligned. It's a minority for sure, but they include some of the brightest and most successful minds in the field.

These include some of the editors of the top journals, which has greatly mitigated the problems I mentioned above. Most (but not all) management journals are sincerely interested in interesting research and are willing to publish even things they disagree with.

Topics of disagreement, based often in ideological differences, are still discussed amiably and scholarly, a state of affairs that cannot be attributed to many other social scientific fields.

If you are an aspiring scholar of the Austrian tradition, you can find a viable home in the business field.

Target Areas For Austrian Advancement

What sort of topics could you study? Let me turn now to a brief overview of what business topics remain ripe for Austrian theorizing. My list of possible research areas is hardly comprehensive, and its bounded by my somewhat limited familiarity with other areas of business research that are not my own. However, I offer it as an overview to young minds as a way to consider your own interests and how your Austrian background might give you a leg up on the 'competition' rather than holding you back.

Entrepreneurship

Let me begin with my own field, and the one that has seen the greatest reemergence of Austrian ideas, which is entrepreneurship. Entrepreneurship is, right now, a young and emerging academic discipline that has strong momentum. This is a great discipline to get into if you're an aspiring Austrian scholar. The current leadership includes several Austrians, and those who are not Austrian are at least sympathetic.

But the field of entrepreneurship has struggled to find for itself a solid theoretical foundation on which to build. That is, there still is no strong and established 'theory of entrepreneurship'. Instead, we have several different perspectives vying for top spot. In this state of affairs, we are presented with a great opportunity to build and develop our Austrian perspective and gather interest and momentum for those ideas.

We can develop and advance subjectivism as a philosophical foundation. We can proffer and further develop the Austrian theory of markets. There is enormous opportunity in work on the effects of policy and regulation on entrepreneurship.

If I were a young Austrian looking for a future career in academia, entrepreneurship would by my first pick (but I might be biased).

Theory of Organizations

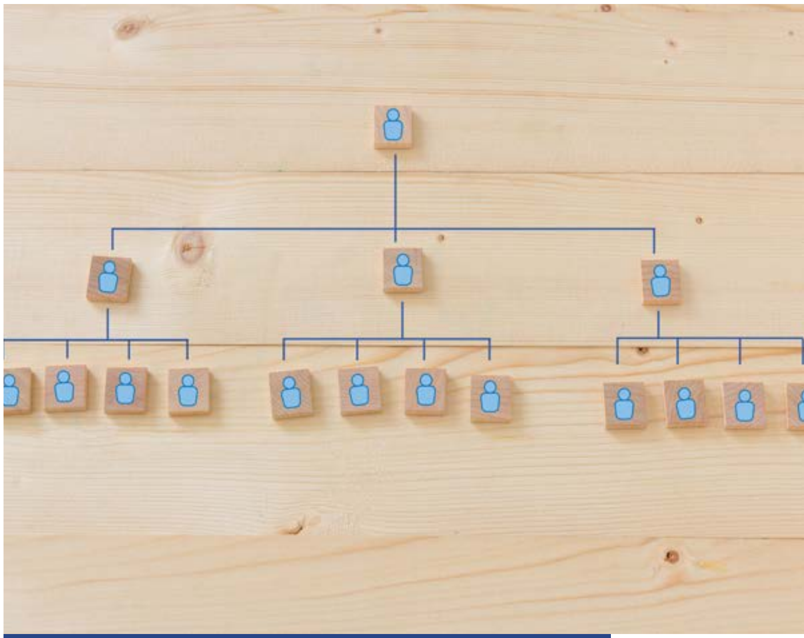
The theory of organizations, or 'org theory', concerns the question of why firms exist, how they are organized, their size and scope, and so forth. Org theory is, perhaps, the oldest and most established of the business theories.

However, it's also the most in need of some disruption. The current theories are good — they are premised on true and important principles — but they are not now sound. There is too much ideology within the theories.

I think an 'Austrian' theory of organizations (I wouldn't call it that) is due. That is, we need a theory of the firm built from the Austrian method.

In fact, we have the start of two good theories of the firm from our own Peter Klein (with Nicolai Foss) and Per Bylund.

But neither of those has gotten much traction, in part because Peter and Per are now focused on entrepreneurship, which is a different subdiscipline.



"I think an 'Austrian' theory of organizations (I wouldn't call it that) is due. That is, we need a theory of the firm built from the Austrian method."

A new theory of the firm would be a career maker. You, and many others with you, could build a vast CV by incrementally building and developing such an org theory. And the field would be much better for it.

Strategic Management

Strategic management concerns how firms (or their management) compete with industry competitors. Its primary tools include Porter's five forces analysis, SWOT analysis, a PESTEL/STEEP analysis, and the resource-based view's VRIN/VRIO analysis.

But the tradition of strategic management emerged out of the industrial organization (IO) strand of economics, where industries were already essentially assumed to be given and relatively constant. The strategic tools developed therefrom, then, focus on strategic positioning within a stable industry. This is not the business environment of today.

Today, many industries are in regular upheaval. Innovation occurs faster than ever, and firms can no longer simply find a strong strategic position and stand comfortably pat. In other words, the tools of yesteryear are largely unfit for the dynamic business world of today.

The primary problem with the modern theories of strategic management, and the tools derived therefrom, is that they are built upon neoclassical economics' roots. General equilibrium theory is at the heart of it all, keeping strategic management static, even if management scholars are unaware of it.

It appears that strategic management scholars are somewhat aware of the problem, and have made recent calls for new research to revamp the old theories. But what is truly needed is an overhaul, a starting over from first principles. We need to scrap the old foundations and build up anew from Austrian foundations. We need a subjectivist Strategic Management.

Again, this is a potential research stream large enough to support the careers of scores of scholars.

Organizational Behavior and Human Resources

The so-called ‘micro’ side of business management is less obviously a target for Austrian theory, generally comprising what Mises called ‘thymology’ rather than the Austrians’ focus on praxeology. However, Mises never discounted the importance of thymology, he merely suggested that it was outside his own praxeological scope. In fact, thymology is a vital field of study for Austrians, one that we have, unfortunately, been reluctant to touch.

This can be seen in the subdiscipline of organizational behavior and human resources (OB/HR), which has so far been the purview of applied psychologists.

Psychology, like economics, got its early start in the scientific philosophy of positivism, an inherently unfit approach to social science that Austrians and

others would disparage as ‘scientism’—trying to use the scientific methods of the natural sciences (like physics) to study people.

As it turns out, people are not non-conscious objects to be studied in the same way as falling rocks and electricity. In a now-famous effort, several psychologists went to work trying to replicate 100 of the most important experiments in psychology, on which the foundational theories of psychology are based. Only 40 replicated.

While psychologists and OB/HR scholars are not merely dismissing the alarming results of the ‘Reproducibility Project’, they simply don’t know what to do about it. So far, the corrective plan has been to simply keep doing the same thing, only better — improve our methods, use more advanced statistical tools, take steps to avoid cheating and manipulation, etc. No one has even stopped to wonder if, maybe, we might be doing it wrong.

A strong presence of Austrians in the thymological studies is desperately needed. Psychology, applied and otherwise, needs the same methodological pivot that economics needs.

Beyond this, there are specific topics that need refreshing from an Austrian perspective. For example, the core idea of ‘human resources’ or ‘human capital’ is an outdated and, frankly, irresponsible approach to business management. Humans are *not* resources, at least not in the same way as other resources. The idea of employees as resources or capital derives from the positivistic and deterministic philosophy of science that Austrians reject.

As it turns out, managers don't get to use their employees in whatever way they choose — employees, instead, choose what and how much they are willing to give their employers.

This agency (or principal-agent) problem implies that there needs to be a whole new set of strategic tools for the management of employees that are very different from those we now have. We need to redefine human capital, and build a new strategic human resource domain atop better definitions and foundations.

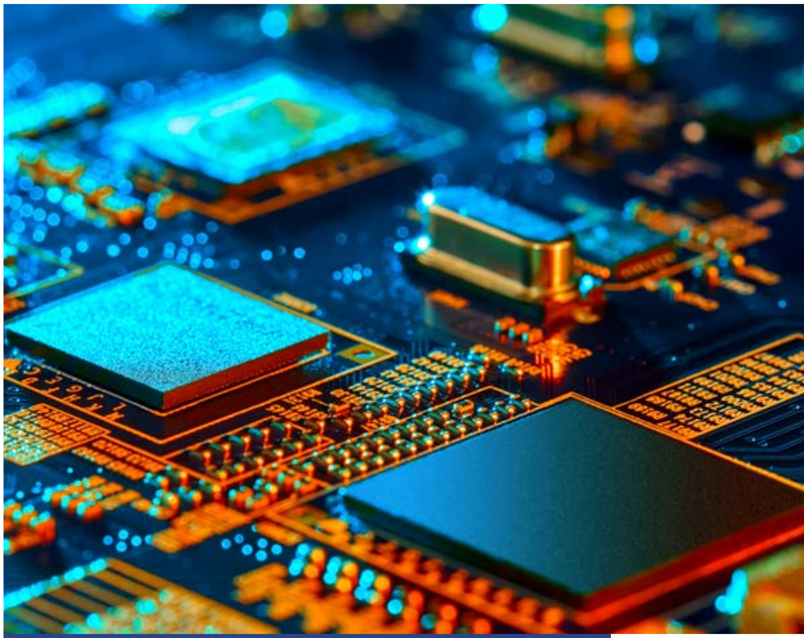
Marketing & Consumer Behavior

I believe there is already a small Austrian presence in marketing, but marketing is ripe for an Austrian revolution. This is exemplified, for example, by the rise of the service-dominant logic (SDL) in marketing.

The SDL reconceptualizes the concept of value away from the 'goods-dominant' embedded utility concept still popular in economics to a 'service-dominant' concept of value as the services or benefits attained in consumption.

Seminal SDL scholars have connected their value concept to Bastiat's work, but have yet to make the connection with Austrian subjective value theory.

One area of desperate need of Austrian subjectivism is the consumer behavior subdiscipline. Consumer behavior is dominated by behavioral economists, who like to treat consumers as manipulable mechanical automata.



> *"As it turns out, people are not non-conscious objects to be studied in the same way as falling rocks and electricity."*

They see people as "predictably irrational" actors, with universal ends that are impeded by biases and cognitive illusions.

They see uncertainty as a probability problem.

Considering the importance of consumers to the Austrian theoretical framework, I think it vital that we destroy the behavioral paradigm in favor of a subjectivist (Austrian) one, that we understand consumer values not as given and universal, but as subjective and evolutionary, and that producers move away from trying to persuade and manipulate consumers and toward listening and responding to consumers. Most firms have already figured this out. It's the entrenched marketing scholar that can't seem to see past his/her own biases.

Finance

I honestly know very little finance theory, but, like marketing, behavioral finance is dominated by behavioral economists. As a result, the field simply does not understand investors or their behaviors nearly as much as they think they do. This field, also, is due for Austrian subjectivism.

One area in finance that I think needs to be revamped atop Austrian foundations is its theory of money and credit. Frankly, I don't think the finance discipline really understands money. And, while some Austrians have inserted Austrian business cycle theory into the economic discussion on credit and banking, the finance discipline remains surprisingly ignorant of Austrian theory.

Accounting

If you want to get paid well while doing Austrian research, accounting is the way to go. Schools have to pay their accounting professors well because, well, no one wants to do it. Accounting theory is largely uninteresting. But it could be.

Accounting is in dire need of an Austrian shakeup. Tax accounting? They're asking all boring questions. Where is the libertarian research on the specific consequences of taxes on firms? Audit and regulations? Where is the research on the dark side of those regulations? Where is the research on the spontaneous emergence of best practices in accounting, and why centrally standardized practice inhibits innovations and custom accounting that works better for individual firms?

In short, there are opportunities for Austrian scholars all over the spectrum of business disciplines. Business research, unlike economics, to which no one really listens except to confirm their ideological priors, has the potential to have a real impact on the world.

There is, right now, a massive academic-practitioner divide in business. Business managers don't listen to academia and, quite often, academics don't listen to business practitioners.

But this divide is mainly because most business research is nonsense. It's garbage in, garbage out. Business managers do and will listen to good ideas. And we Austrians have good ideas. I think this comes out loud and clear in the Economics for Business project and in the Economics for Entrepreneurs podcast. We have the answers businesses are looking for. But we need help developing and teaching them.

How to Present the Ideas: Counterhistory or Reinvention?

In some research with Professor Per Bylund, we propose to the management field that a 'counterhistoric' approach to theory building might be a productive path forward. By 'counterhistory' we mean revisiting historical debates and arguments from long since past 'critical junctures' where the mainstream might have, in fact, taken the wrong path forward. It turns out there are many such critical junctures in social scientific history, which provides us the list of areas needing improvement that I've just proffered.

In fact, the main argument of the Austrian school is that economics took such a wrong turn in the early 20th century, and we should have stayed on the subjectivist path of the Austrian school, which was prominent at the time.

Until the field realizes that counterhistory is a valid and useful approach to doing science, we are left, instead, with the option of 'reinvention' — of developing those same ideas, once already well developed, as if they were new.

This actually happens quite a bit in social science, unintentionally. Scholars, unaware of previous work on a topic, submit that research to editors and reviewers unaware of prior work on that topic (like the aforementioned service-dominant logic in marketing).

But as Austrians, we have a solid opportunity to take advantage of the knowledge and theoretic history that we have, and the insights that they bring to bear on current problems.

The idea is to repackage the ideas to the modern audience such that they become new and interesting to that audience. Murray Rothbard's *Man, Economy, and State* is such an approach, in essence rewriting Mises's *Human Action* in a way that would be more accessible and interesting to the profession of his day.

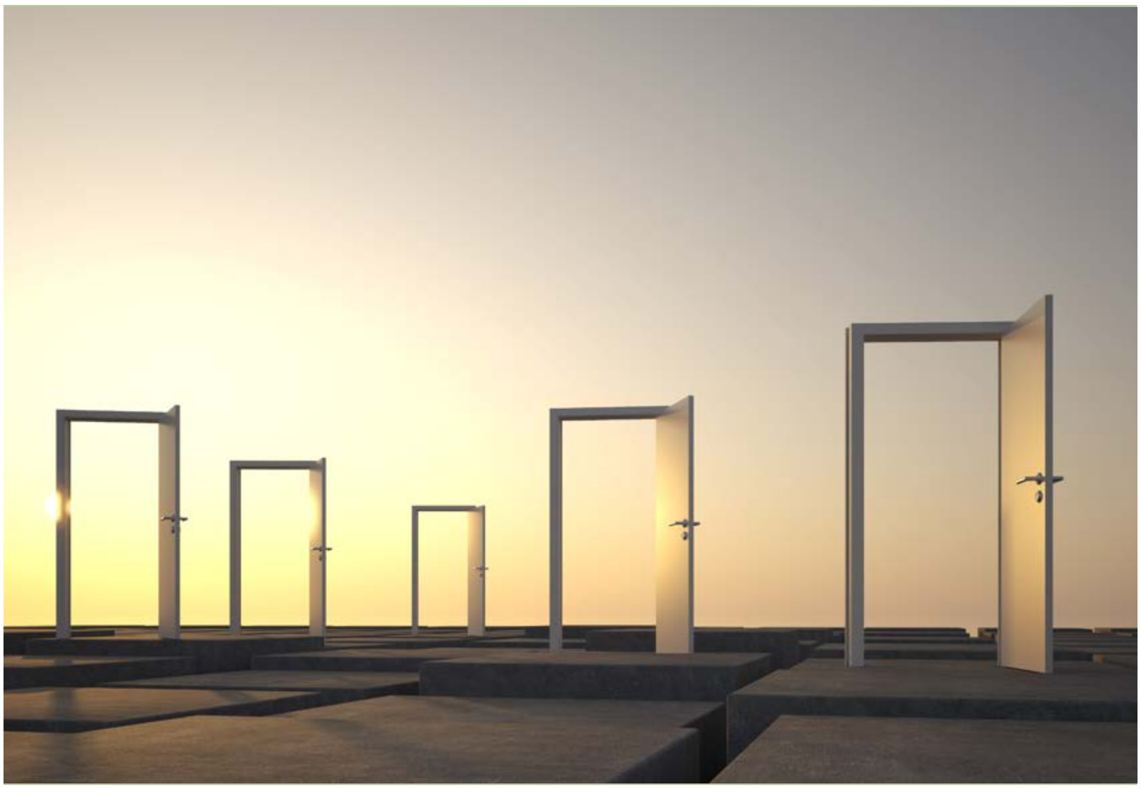
The way to publish Austrian ideas in the modern business fields, for the time being, is to present them as essentially new, which they are to the field you'd be writing to.

This gives us the opportunity to develop those Austrian ideas further while, at the same time, generating new interest and sympathy for Austrian ideas among active scholarship.

Conclusion

The takeaway I want to leave you with is that, if you're seriously interested in Austrian ideas, academia could be a very good career choice. You can make it as an Austrian academic, and you can live quite comfortably doing it (business professors get paid much more than our economics counterparts, on average).

There are tons of research opportunities, and we need help getting our message out. We need to turn the whole business discipline Austrian. It's time for a paradigm shift.



> *"The way to publish Austrian ideas in the modern business fields, for the time being, is to present them as essentially new, which they are to the field you'd be writing to."*

CHAPTER 6

MAKE YOUR STARTUP AN ISLAND

Per Bylund, Assistant Professor of Entrepreneurship & Professor of Free Enterprise at Oklahoma State University

Austrian economics corrects many errors of the past. Most of those emanate from an incorrect view of the economy as a static system of allocation rather than a dynamic process of value creation. One such is the exclusion of entrepreneurs from economic analysis, which has led both theorists and policymakers astray when dealing with the real economy.

A related and seemingly inconsequential problem relates to the use of rhetorical devices to guide entrepreneurs. We typically rely on examples, analogies, and metaphors to produce images of what we mean. They are intended to help us communicate an understanding that takes much less effort than analyzing theoretical models or explanations. But they also introduce problems of interpretation if they are not used carefully.

When put into practice, metaphors that convey the wrong idea or understanding are much more destructive than it might first seem.

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By dressing an important insight in the wrong language or using a misleading example, the efforts of entrepreneurs and businessmen can be undermined. To the degree that they extend and continue the reasoning of the analogy, their actions will be misguided. As a result, the wrong metaphor can make it impossible for them to achieve success.

The errors of improper understanding of the economy can thereby be greatly augmented by using the wrong illustration. This is, unfortunately, the case with common metaphors used to illuminate business practice.

Misleading Military Metaphor

On particularly unproductive error is how the language of business strategy is overwhelmingly militaristic. Markets are conquered, competitors are fought, and revenue streams are protected with moats. While strategizing is indeed a core component of both business management and military campaigns, their respective means — and aims — are hardly the same. Contrarily, they are *the very opposite.* This makes this rhetoric both misleading and unfortunate.

A moat, to use one of those oft-used military terms in business, was an important part of the defense in the age of kings, knights, and fortresses. It serves to keep outsiders out, to control and stop anyone from entering. But this makes no sense for a business.

Sure, we can stretch the metaphor to be about protecting already conquered market territories, and thus the moat becomes a means of protecting a niche or market segment from enemies (competitors) wishing to capture the land of riches. So you protect “your” customers from other sellers.

The problem, of course, is that there is no such land of riches. The entrepreneur does not in fact conquer or occupy a territory; the entrepreneur is no king of the realm.

The very opposite is true: the entrepreneur is a servant aiming to please the customer. The customer (ultimately, the consumer) is the sovereign. What does the military metaphor then convey? That the servants are waging war to supposedly conquer the right to serve the sovereign?

It makes no sense.

A different metaphor is needed to avoid causing confusion and get closer to what it means to be an entrepreneur and to create a business.

In addition to making intuitive sense, a useful metaphor must be an accurate figurative representation beyond what is immediately recognized. In other words, it should work also when stretched somewhat so that it can provide guidance beyond the purely descriptive.

I have previously suggested thinking of the firm as an *island of specialization.*

This is, I believe, an apt metaphor that can be used without immediately misleading the user. It also gives a new perspective on the firm — and a productive way to think about one’s business.

To see why this is an apt (and therefore helpful and productive) metaphor, we need to first take a step back and look at what the market economy is about.

> *“Austrian economics corrects many errors of the past. Most of those emanate from an incorrect view of the economy as a static system of allocation rather than a dynamic process of value creation.”*

The Market As A Process

While most economists think of the economy as a static relationship between supply and demand, this is hardly a realistic view of the economy. For one thing, if supply and demand are rather static, where does economic growth come from? Where does entrepreneurship fit in this picture? While this model suggests a reason for military language (the market is a limited space to be conquered or lost), the model, sadly, has room for neither growth nor entrepreneurship.

The market economy is better understood as a process, an endless “discovery procedure” in which entrepreneurs figure out new and better ways of providing goods and services that consumers appreciate. It is not a smooth process, but one that sometimes takes leaps forward and at times does not seem to be moving much at all. It depends on the successes (or lack thereof) of entrepreneurs in imagining how to better serve consumers.

From a market process perspective, entrepreneurs are constantly searching for better products, more effective production processes, simpler ways of running businesses. And they glance at and learn from each other, thereby continuously adjusting their efforts to create more value. From time to time, someone comes up with a good or service that gets widely adopted and changes consumers’ behavior.

This disrupts the market, undermining some entrepreneurs’ business models while opening new opportunities. Entrepreneurs adjust to this new situation quickly or succumb to the change.

Seeing this process from the point of view of consumers, this constant change is directed toward facilitating more value creation. That is what better products and services means; that's also what more products and services mean; and it is what increased productivity means. Everything aims, directly or indirectly, to please consumers, whatever their wishes and wants turn out to be. Market progress, it follows, is economic growth which is, in turn, increased wellbeing for consumers. And we are all consumers.

Economy As Production

Economists of old focused on this process in terms of productivity efforts, and especially producing more (value) for less (cost). It is thus a matter of using the most productive resource of all — labor — in the best way possible. How do you get more output from labor? One way, not very effective but tried for millennia, is to simply have people work more hours.

A much better way is to use labor power in *smarter* ways and have people collaborate in production. By having people specialize and develop specific expertise, their productivity increases immensely. But it also means production is organized in processes where different people do different things: the power of labor in production is divided into many different tasks. For this reason, Adam Smith begins his magnum opus *The Wealth of Nations* with several chapters discussing this phenomenon: the division of labor.

While it was true hundreds of years ago, it is just as true today. The market process progresses through adopting ever more intensive specializations. The expertise needed for common jobs today is much, much deeper yet also narrower than was the case only decades ago. This is the outcome of imagining new products that were never before produced. But it is also about doing things differently (such as Henry Ford's introduction of assembly line production in automobile manufacturing). More tools are innovated, which need people specializing to produce them.

> *By having people specialize and develop specific expertise, their productivity increases immensely.*

What is interesting in this process is that it keeps moving ahead without our noticing it. And it happens through entrepreneurs imagining new things they can produce and new ways to produce them. We do not always see it, because what is right in front of our eyes appears normal and not a step ahead from yesterday and a stepping stone for a different tomorrow.

So entrepreneurs are in a very real way in the business of creating our tomorrow. Which takes us back to the role of the entrepreneur and the firm as an island.

The Role Of The Entrepreneur

Core to the market process of constant change, the discovery procedure in which we collectively figure out new and better ways to serve consumers, is the entrepreneur's production undertaking. Typically, entrepreneurs realize their imagined product through a firm. To be successful and earn a return, it is not sufficient to simply copy what others are already doing.

This point is obvious if we consider the market's constant progression. Production takes time. If you start doing today what others are already doing today, you'll not have a product to sell until a later time — when other entrepreneurs have already moved on. So copying what others are doing in the present will put the entrepreneur in an endless game of catch-up.

But more pertinent is that consumers change their minds and their behaviors. Just because something sells well today doesn't mean it will sell well tomorrow. So to be successful *at all*, the entrepreneur needs to imagine what the future will be like and attempt to meet it. The best way of doing this is to try to place oneself in the customer's shoes and figure out better ways to serve him or her.

The Firm As An Island

What this means is that the firm is not simply a production facility like any other, and shouldn't be. It should be a reflection of the entrepreneur's imagination of what needs to be done — and how — to meet the imagined future.

In other words, the inside of the entrepreneur's firm is different from the surrounding market. Perhaps other production processes are used, they are organized differently, use different expertise or management techniques, unique tools, etc.

The firm, then, is an innovation in itself: it is something unique that represents the entrepreneur's best guess for how to realize the imagined future given what resources (including, most importantly, people and their skills) are available. It should therefore also evolve over time, both as adjustments to changes in the market overall (including competitors) and as implementations of new or updated visions of the future.

But how is this an island?

The firm is an island of specialization because it utilizes a unique way of organizing resources, unique knowledge and expertise, and is thus different from the rest of the market (the ocean).

It also provides direction for others, whether they are competitors who need to adjust to the firm's innovations, people seeking employment where they can better leverage their skills, or customers looking to be served better.

"[The firm] should be a reflection of the entrepreneur's imagination of what needs to be done — and how — to meet the imagined future."

The firm is an island also because it is a structure that provides solidity to amoebic, sometimes seemingly anarchic, production processes and that both suppliers and customers can rely on over time. It is an aggregate of resources and processes with a uniform exterior and brand that you know and trust whether or not its internals, both people and processes, stay the same. It is firm ground in an otherwise ever-changing and treacherous ocean.

The entrepreneur's task is to keep building the island by expanding its land mass and height, to make sure it remains attractive and can provide satisfaction to visitors and those settling there for longer time periods. It is also important to protect the island and its inhabitants from storms and counter erosion as waves keep rolling in from the ocean.

Note how this is different from the militaristic metaphors. The market economy is the ever changing, and possibly treacherous, ocean within which the entrepreneur can establish an island as a safe haven.

The role of entrepreneurs, managers, and businessmen is then to make the island as habitable and attractive as possible, to support and facilitate trade relations with other islands, and build infrastructure and supports to protect it from storms and other weathers that can wreak havoc on island life.

Rather than focusing on destructive conflict, the island metaphor focuses on the firm as a system — or even organism — that is related to other islands and surrounded by an ocean.

This ocean, to extend the metaphor, can be calm waters facilitating transportation and inter-island relationships, access to resources (think fish to eat), etc. But it can also bring stormy weathers, untamable waves, and cause ships to go under.

These weathers cannot be controlled, but a well-prepared island community can ride out even bad storms.

Certainly, there is also room for violent conflict. But the focus is on productive efforts, on building and creating, and on creating and maintaining valuable relationships. It is also a focus on internal affairs and the reciprocal nature of relationships, the wellbeing and welfare of those who are inhabitants or temporary visitors to the island.

> *Rather than focusing on destructive conflict, the island metaphor focuses on the firm as a system — or even organism — that is related to other islands and surrounded by an ocean.*

The firm as an island is also instructive for development and investment, as a barebones island would be unlikely to attract both inhabitants, visitors, and trading partners. An island is further of little use unless it can be sufficiently elevated above the ocean to not be submerged as sea levels rise or extreme weather causes tsunamis.

The island is a far cry from the fortress intent on keeping others out by raising obstacles and building military might to repel enemy forces or subdue neighboring lands.