Preface

Much of current management thinking owes a great debt to Austrian economics. To be sure, this influence is largely indirect. But the person who is arguably still the dominant thought-leader in management studies, the Austrian-American Peter Drucker, was well-versed in Austrian economics. In fact, as a young man he met and interacted with key Austrian economists, notably Ludwig von Mises, Joseph Schumpeter, and Friedrich Hayek. Little research exists on the Austrian roots of Drucker's thinking, but it is a plausible hypothesis that many of his key ideas – such as his emphasis on decentralization in business firms, the role of knowledge workers, importance of innovation as the only lasting source of competitive advantage, and skepticism about macro thinking – reflect his exposure to the Austrian tradition.[1]

In a similar way, we believe there is huge unexploited potential for bringing Austrian economic ideas into management thought. More generally, we believe that in many important ways Austrian economists speak a language closer to the one spoken by management scholars than to the language of mainstream economics. This book is therefore written in the belief that Austrian economics still has much to offer to management studies. Our dominant Austrian influence is Ludwig von Mises. This may at first seem strange, as F.A. Hayek's ideas have often been drawn upon in management studies, while Mises remains a less appreciated figure. And yet, Mises' thinking on the entrepreneur and the market process is in many ways different from Hayek's and is perhaps of even greater relevance to management research. We therefore dedicate this book to the memory of two very different, but both towering (in their respective domains) individuals, Ludwig von Mises and Peter Drucker.

We are grateful to JC Spender for suggesting the idea for this Element.

1 Introduction

The Uniqueness of the Austrian School

The "Austrian" school of economics, named for its nineteenth-century origins in Vienna, is well-known for its contributions to economics over the past century-and-a-half. To take only a few examples, Austrian economists pioneered the economic critique of socialism and the analysis of the entrepreneurial market economy; their ideas were used to predict and to explain both the Great Depression and the Great Recession; and Austrian scholars have also launched radical and unique criticisms of organizations and policies, including monetary and banking institutions. Yet while the methods, concepts, and theories of the

[1] The exception is Kiessling and Richey (2004).

Austrians have mainly been applied in their home discipline of economics, they are also becoming more widespread in management studies. This is especially true in the disciplines of entrepreneurship, strategy, and organization studies.

In general, many Austrian school ideas are not only compatible with, but also, we shall argue, provide superior foundations for contemporary management studies. However, many management scholars, practitioners, and educators have little knowledge of Austrian economics or know it only through its association with libertarian political philosophy. Austrian economic ideas are still not taught in many university and business school programs. Furthermore, over the long history of the school some of its ideas have been absorbed into the economic mainstream and are no longer treated as distinct contributions.[2] Nevertheless, many of its core ideas have not, and it is those on which we focus in this section. We specifically have in mind Austrian ideas about the subjectivity of decision-making, dispersed knowledge, heterogeneity of capital, importance of uncertainty and entrepreneurial decision-making, and the need to provide a realistic, causally-informed understanding of economic processes. Thus, one overall purpose of this Element is to argue broadly for the usefulness of Austrian economics in informing and furthering management research. An indispensable part of this, of course, is providing introductions to those Austrian ideas with the potential to do so.

The Relevance of Austrian Economics to Management Thought

The many unique emphases of Austrian economics – its focus on realism, causality, value, consumer choice, prices, uncertainty, process, entrepreneurship, heterogeneous capital, and social coordination – make it ideally suited as a foundation for many management disciplines. For instance, each of the three major examples mentioned in the previous section is based on a unique understanding of the role of entrepreneurs in society: the performance of socialist economies depends on their ability – or lack thereof – to draw on the entrepreneurial division of labor; business cycles can only be understood by considering how entrepreneurs behave during booms and busts; the economic implications of alternative banking institutions depend first and foremost on how entrepreneurs create and use them.

If we turn from entrepreneurship to the seemingly very different topic of the internal organization of companies, Austrian economics also has much useful insight to provide. One example has to do with what Austrians call the "division

[2] We admire much of so-called mainstream economics and do not reject the use of formal methods in theory and empirics as such. However, we do think that mainstream economics has a number of "blind spots".

of knowledge" (a way to emphasize the point that the division of labor is usually accompanied by a corresponding specialization in terms of knowledge). The first economist to persuasively suggest that the division of knowledge has enormous implications for organization was F. A. Hayek, who specifically argued that the division of knowledge requires decentralization. Utilizing knowledge that is highly relevant for decision-making, but that is also dispersed, fleeting, etc., requires that the decision-maker be given the right to act on that knowledge. Arguably, many companies committed to overly hierarchical decision structures have yet to absorb and understand this basic idea, which was the primary motivation behind the award of the Nobel Prize in Economics to Hayek in 1974.

To take another example, beginning with the school's founder, Carl Menger, Austrians have also often emphasized that many of society's most valued and important institutions are products of partly "blind" social processes.[3] That is, they have not been explicitly designed by anyone, but have nevertheless emerged to serve a useful social purpose. This is true of some of our most fundamental institutions, from money to key aspects of property-rights and the law, etc. Of course, great thought leaders as well as politicians (only weakly overlapping sets) have also intervened in the process of social evolution and partly shaped its course, but much of what is fundamental in the fabric of social life has emerged spontaneously. This idea is also most directly associated with Hayek's research.[4]

Similar points could be made about the "social life" of companies. Companies have cultures, shared values based on often unstated assumptions. Their attempt to make their cultures explicit may lead to the formation of identities that then become part of their mission statements. This can in turn lead to the belief that cultures can be easily manipulated to serve certain company-specific purposes. According to management professor folklore, when the culture craze was at its height in the late 1980s, consultants would get requests from CEOs to "get me a new culture by next week" – and some consultants would in fact claim that they could do this. Of course, anyone with a basic knowledge of how deep-seated and fundamental culture is will be highly skeptical of such claims. Rightly so, as Hayek's work suggests that culture is hard to change precisely because it emerges to serve the changing needs of

[3] This theme originated during the "Scottish Enlightenment" through thinkers such as David Hume, Adam Ferguson, and, of course, Adam Smith.

[4] Although Hayek received the Nobel Prize in 1974, he had effectively stopped writing about technical economics several decades earlier. After World War II, most of his work was dedicated to refining his views on classical liberalism and embedding them into an ambitious and sweeping theory of cultural evolution.

people dealing with specific challenges, but also gets internalized in the form of tacit and typically rigid rules of behavior. Thus, in many ways Austrian economics provides a more realistic understanding of the challenges of changing what is colloquially called "corporate DNA," that is, the basic assumptions, beliefs, etc. that characterize the organization.

As a final illustration of the relevance of Austrian economics, consider Corporate Social Responsibility (CSR), currently a highly fashionable trend in management thinking and in managerial practice. Obviously, CSR reflects very much the *Zeitgeist*, specifically, ideas about the overriding importance of sustainability in terms of husbanding the planet's resources, particular ethical positions about business practices, and the claim that people should have some power over the broader social forces that influence them. Thus, CSR puts together "green" concerns, business ethics, and an extended notion of "democracy." While much of this may sound laudable and appealing, Austrian economics warns that much of CSR thinking may rest on shallow foundations.

The fundamental point is that if companies are to make rational decisions concerning CSR actions, they need a way to compare different actions; that is, as Mises (1920) pointed out almost 100 years ago, a common metric is required. His specific argument was directed against the claims of utopian socialists who wanted to abolish markets, centralize resource allocation, and, in classical Marxist fashion, let resources be allocated according to "needs." Mises argued that if markets (in particular, those for capital goods) were eliminated, prices would also cease to exist. Without prices, decision-makers would not know how to make the best use of productive resources because there would be no uniform signals that could be relied on to steer resources to their most valued ends. Profit and loss estimates would be impossible, and the net present values of alternative investment projects could not be calculated. Like utopian socialist planners, many proponents of CSR do not provide a way to assess which CSR investments should be undertaken, how much should be invested, and so on. There is no common metric that can be used for this purpose, or rather, the one that exists, namely, profitability, is often frowned upon. Decision-makers are groping in darkness.[5]

What This Element Does

This Element provides a concise overview of the role of Austrian economics in management studies. We highlight both its current achievements and some

5 An emphasis on CSR, and on giving decision-making authority to a broader set of stakeholders besides the firm's owners, is also in conflict with the Misesian idea that, under uncertainty, entrepreneurship is embodied in ownership and that equity holders have unique advantages in exercising the ownership function (Foss and Klein, 2018).

promising new research directions, some of which we have hinted at already and will discuss further in the following. The Element is intended for management researchers as well as advanced students interested in Austrian economics and what it has to offer the various disciplines within management studies. While we seek to be broad and general, we obviously cannot cover all of management research. Thus, we do not deal with some major disciplines like organizational behavior, operations management, and marketing. While we are confident that Austrian economics also has implications for these areas, our knowledge of them is too meager to offer any particular insights. Thus, our coverage is restricted to the fields of entrepreneurship, strategy, organization, and general management. These are, of course, fields that also inform a number of neighboring areas such as technology management and innovation, international business, and, to some extent, human resource management, all of which are relevant to Austrian economics.

An Overview

We begin in Section 2 with a primer on Austrian economics that surveys key Austrian ideas and briefly links them to important ideas in management thought. These links are then unfolded in the subsequent sections. Section 3 studies the theory of entrepreneurship in detail, explaining some unique Austrian contributions and how they inform contemporary entrepreneurship studies. Section 4 then expands the traditional theory of entrepreneurship in the market to account for alternative forms of entrepreneurial action in social enterprises, political organizations, and among institutions more generally. Section 5 discusses the entrepreneurial foundations of strategy research, and Section 6 explains the entrepreneurial foundations of the theory of the firm. Section 7 concludes with a brief survey of several emerging trends in Austrian management research.

2 What is Austrian Economics?

Origins

The Austrian school was one of three major strands of "neoclassical" economics to emerge from the "marginalist revolution" of the 1870s. The founding of the school is usually dated to 1871, the year economist Carl Menger published his *Principles of Economics*.[6] In it, Menger provided a unique account of economic

[6] Importantly, many of the ideas central to Menger's work and that of his followers—including, for example, the emphasis on the role of the entrepreneur—had been hinted at by earlier economists like the nineteenth-century French liberals. Similarly, Menger's emphasis on invisible-hand processes and the un-designed nature of key social institutions derives from the Scottish Enlightenment (e.g. from Hume, Ferguson, and Smith).

behavior, especially of the theories of value and price, which he explained were rooted in the subjective attitudes of individuals. His writings inspired the work of many other notable economists, including Eugen von Böhm-Bawerk, Friedrich von Wieser, Ludwig von Mises, Wilhelm Röpke, F. A. Hayek, Fritz Machlup, Oskar Morgenstern, Ludwig Lachmann, Murray Rothbard, and Israel Kirzner. These economists spanned about four generations of academic economists, and together they formed the core of what is known as the Austrian school. In more recent decades, Mises, Rothbard, and Kirzner in particular, and to a lesser degree, Hayek,[7] Machlup, and Lachmann, directly inspired many younger – mainly American – economists to adopt the Austrian label.[8]

Many other prominent economists have worked in or around the Austrian tradition, including Philip Wicksteed, John Bates Clark, Frank A. Fetter, and William H. Hutt. More recent examples of sympathetic fellow-travelers include British economists G. L. S. Shackle, Jack Wiseman, Brian Loasby, and Stephen Littlechild. And many more mainstream economists have given credit to Austrian school economists for particular ideas. For example, economists as different as Nobel Prize winners Kenneth Arrow, Douglass North, Edmund Phelps, and Oliver Williamson have all praised Hayek's insights about dispersed knowledge.

The most famous name among the economists associated with the Austrian school is that of the brilliant and iconoclastic Joseph Schumpeter. Schumpeter was not a member of the "mainstream" Austrian tradition and was reluctant to be considered a member of any school of thought, but his emphasis on the entrepreneur and historical processes, as well as his skepticism of macroeconomics and his insightful analysis of the role of politics and ideology, places him close to the Austrian camp. At the same time though, his fascination with econometrics and mathematical economics distances him from the Austrians. The work of the great American economist Frank H. Knight (1921) likewise shares some key themes and insights with the Austrian school – notably his emphasis on entrepreneurship and uncertainty – and in our discussion of Austrian perspectives on entrepreneurship we reference some of his most relevant ideas.

[7] Hayek's case is somewhat special. As the only Austrian Nobel Laureate, his influence has naturally been enormous. However, his main direct influence on younger economists took place in the 1930s after he became Tooke Professor at the London School of Economics (LSE), a position he held until World War II. However, few of Hayek's many brilliant students and followers at LSE became Austrian economists, and a number of them, notably Abba Lerner and Nicholas Kaldor, in fact became associated with socialist positions.

[8] These include Mario Rizzo, Joseph Salerno, Roger Garrison, Lawrence White, Peter Lewin, Peter Boettke, and their followers and students. Thus, the history of Austrian economics in the United States now spans three generations. On the modern Austrian school, see Vaughn (1994) and Salerno (2002).

Given this colorful cast of characters, it is well to ask what makes Austrian economics unique and valuable. Its first notable characteristic is its scope. Austrian economics attempts to offer a wide-ranging but integrated account of economic relations, with a focus on *realistic* explanations of the *causal* relationships between economic phenomena. In other words, it seeks to understand value, prices, and other economic facts as they exist in the world, rather than how they might behave under highly abstract or unrealistic conditions, such as long-run equilibrium. Austrian economics looks at economic behavior "warts and all", and grapples with difficult problems like the uncertainties and errors that plague human action, and what they mean for society at large. We argue that this emphasis on realism is one reason Austrian work is ideally suited for the study of both theoretical and applied problems in the management disciplines.

It is difficult to reduce Austrian economics to only a few ideas; nevertheless, a limited review of some of its most important contributions is necessary. Austrian economics is most distinct in its approach to "mundane" economic topics, especially "price theory, capital theory, monetary theory, business-cycle theory, and the theory of interventionism" (Klein, 2008a). We choose to focus here on themes that are usually included among the first two of these topics. These themes are: subjectivism, tacit and dispersed knowledge, capital, time and uncertainty, and entrepreneurship. These topics lie at the heart of Austrian approaches to management studies, particularly issues germane to entrepreneurship, strategy, and the theory of the firm. Unpacking them will help underline a vital conclusion that frames much Austrian work in these fields: the market is not a static or equilibrium state, but rather a dynamic process in which individuals use the price system to coordinate their actions and improve their welfare over time. Entrepreneurs play the leading role in this process, which is therefore also a starting point for investigating a wide range of problems in management studies.

Austrian Economics: Key Concepts

Methodological individualism. Austrian economists are often associated with "individualism". However, individualism comes in different forms. Thus, laymen associating Austrian economics with individualism often have *political* individualism in mind, as in the political philosophies of classical liberalism or libertarianism. It is true that many Austrians have been associated with individualism in this sense.[9] However, Austrian economics per se is, as Austrians

[9] Not all, however. For example, Friedrich von Wieser and, somewhat later, Richard von Strigl, were not liberals, while Frank A. Fetter was jointly influenced by early progressivism and liberalism.

insist, "*wertfrei*" in the sense of Max Weber: value-free, neutral, and not prescribing any political stance. Indeed, when it is said that Austrian economics is built on individualistic premises, something quite different is meant. Austrians subscribe to *ontological* individualism, that is, the position that ultimately only individuals can truly act. When we routinely ascribe agency to collectives or corporate persons this is an "abbreviation" representing a complex web of interdependent decision-making. The closely related *methodological* position asserts that individuals and the things they perceive, like, plan, do, etc. are the ultimate building blocks of social science. Collectives such firms, groups, divisions, etc. can ultimately only be understood in terms of individual action and interaction. As Menger (1883: 158–59) stated, "[Orders] as a rule are not the result of socially teleological causes, but the unintended result of innumerable efforts of economic subjects pursuing individual interests." In fact, the term *methodological individualism* was coined by Austrian economist Joseph Schumpeter (1908).

Similarly, relations between collective entities ("Chinese tariffs caused the US to respond with tariffs on US produced goods," "the actions of Firm A provoked a reaction from Firm B," "capabilities cause profits", etc.) can only be understood in terms of their underlying patterns of individual action and interaction. This was a major point in Menger's (1883) critique of the German Historical School (particularly of its best-known proponent, Gustav Schmoller). Extreme structuralist positions in sociology, according to which individual action is entirely determined by structural roles, is one articulation of the opposite position of *methodological collectivism*. Since individuals are anonymous occupants of structural roles and are in essence alike, they are of little or no analytical interest, and any attention should center on macro structures. Modern economics, particularly macroeconomics, sometimes also slips into methodological collectivism of this sort. Students of basic Keynesian theory may remember notions of "C", "I", "Y" and other macro aggregates, and somewhat mysterious arguments about how these aggregates are linked through "multiplier" processes (Lachmann, 1969).

In fact, even management theory often makes use of methodologically collectivist arguments. This may come as a surprise, because "management" is usually taken to be, literally, the management of men (and women), clearly a very "micro" activity. Indeed, one of the key founders of modern management theory, Chester Barnard (1938), argued that "management begins always and everywhere with the individual". However, much management theory is as methodologically collectivist as sociology in that it emphasizes structures, practices, routines, capabilities, competencies, and other constructs over the individuals who comprise them. While such collective or aggregate constructs,

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usually deployed at the level of firms, have their place in management thinking, they are persistently used without clarifying how they relate to individuals' feelings, tastes, plans, etc. In other words, much management thinking is unfortunately, by design or default, not in conformity with the implication of methodological individualism that "we shall not be satisfied with any type of explanation of social phenomena which does not lead us ultimately to a human plan" (Lachmann 1969: 154).

In sum, Austrians subscribe to a "microfoundations" approach. So do most modern economists, of course, but microfoundations can take different forms. Indeed, Austrian microfoundations differ from those of mainstream economists in several key respects. Nevertheless, the Austrian variant based on a methodological individualism, which highlights the plans individuals form in order to pursue their goals, continues to provide valuable foundations for entrepreneurship and management research (McCaffrey, 2018a).

Subjectivism. Austrian economists from Menger onward have emphasized that value is subjective. That is, "value" is not something inherent or objective that exists within a good, but describes a relation between a valuing person and an object being valued.[10] Tastes and preferences differ both between individuals and for the same person over time, and the basic architecture of choice includes many subjective elements. For example, costs and benefits, and the incentives they offer, must ultimately be understood with reference to the subjective views of individuals. The same is true of the foundational economic concept of opportunity cost, which is simply a reflection of a particular person's preference rankings (Buchanan, 1969; Newman, 2018).

The notion of subjective value, though simple, has far-reaching consequences for the way economic theory is developed and applied. In particular, it places the individual consumer at the center of economics. It implies, for example, that the prices of all consumer goods and services, as well as all factors of production (land, labor, capital), can be traced back to individual preferences and to marginal decision-making. The end of all production is consumption, in other words, the creation of value for consumers. And it is with consumer welfare in mind that economic behavior is organized. Value is "imputed" through each stage of production, starting with consumers assessing the worth of final products and continuing until eventually their valuations touch the prices of all factors of production in the economy. The prices of the factors reflect their marginal contributions to the creation of useful final goods for consumers, and

[10] While neoclassical economics also incorporates subjectivism in terms of the preferences and (sometimes) beliefs of decision-makers, Austrians embrace a more thoroughgoing subjectivism, as will become clear.

combining and allocating factors is the job of entrepreneurs. Crucially though, the ultimate test of entrepreneurial success lies with consumers, whose decisions to buy and not to buy determine profits and losses. In a competitive market economy, consumers are "sovereign" (Mises, 1949: 270–272; Hutt, 1936).

Tacit and Dispersed Knowledge. Austrians have extended the idea of subjectivism of preferences to include subjectivism of knowledge, information, and expectations. Thus, Hayek (1937, 1945, 1952) famously argued that not only is knowledge dispersed across the multitude of individuals that make up the division of labor, it is also "tacit" and "subjectively held." Thus, the knowledge that matters for economic decisions is mostly idiosyncratic "knowledge of the particular circumstances of time and place" (Hayek, 1945: 521). Such knowledge is experiential (rather than vicarious) and may be difficult to articulate explicitly. As such, it is difficult to transmit to, for example, a central planning board. This insight is the essence of the knowledge-based critique of socialism (Hayek, 1935, 1945), one of two key Austrian lines of thought on the problem of central planning (the other being Mises's entrepreneurial "calculation" argument; Salerno, 1990a, 1990b, 1993). Furthermore, because individuals' knowledge is mainly idiosyncratic and experiential, they typically interpret "the same" information differently (e.g., Hayek, 1952). Hayek's insights formed the basis of Ludwig Lachmann's point that, because they hold different knowledge and different interpretive frameworks, individuals will hold different expectations (Lachmann, 1977). These in turn influence investment, financing, and production decisions, and are thus intimately bound up with the whole structure of the economy.

Austrian ideas about the tacit, dispersed, and subjective nature of knowledge dovetail in many ways with current management thinking. Thus, organizational theory has long understood that the decentralization of organizational structures is dependent on the dispersed nature of knowledge (e.g., Galbraith, 1974). The branch of management theory known as "knowledge management" (Easterby-Smith & Lyles, 2011; Foss & Michailova, 2009) deals with many of the same kinds of questions that informed the "socialist calculation debate" of the 1930s – for example, to what extent can knowledge be centralized in the hands of a planning agency, and what are the barriers to knowledge flows from individuals (individual units) to the agency? Like Hayek (1945), this literature highlights tacit knowledge as a key barrier. The subjectivity of knowledge and expectations are also central to management research. Thus, scholars often stress how organizations may form their interpretive frameworks for making sense of what goes on in their environments (Foss, Klein, Kor and Mahoney, 2008). Such frameworks include what Penrose (1959) called the firm's "image"