

CHAPTER 2

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Entrepreneurship and Corporate Governance[†]

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936 In his “closing salvo” in the socialist calculation debate, Mises (1949,
937 pp. 694–711) argued that the market socialists failed to understand the role of
938 financial markets in an industrial economy. Even with markets for consumer
939 goods, he explained, socialism would fail because it substituted collective own-
940 ership of the means of production for private capital markets. Through these
941 markets, owners of financial capital decide which firms, and which industries,
942 receive resources to make consumer goods. In a modern economy, most
943 production takes place in publicly held corporations. Of prime importance,
944 then, is the problem of corporate governance: How do owners of financial
945 capital structure their agreements with those who receive that capital, to
946 prevent its misuse? Unfortunately, there exists little research in this area from
947 an Austrian perspective.

948 In this chapter, I focus on the financial-market entrepreneur—what Roth-
949 bard (1962, 1985) calls the capitalist-entrepreneur—to outline some features
950 of an Austrian theory of corporate governance. I begin by reviewing the tradi-
951 tional, production-function theory of the firm and suggesting two alternative
952 perspectives: that of the entrepreneur and that of the capitalist. I next discuss
953 the Coasian, or “contractual” approach to the firm and argue that it pro-
954 vides a useful organizing framework for Austrian research on the firm. The
955 subsequent section proposes entrepreneurship and economic calculation as
956 building blocks for an Austrian theory of the firm. Finally, after a brief review
957 of capital-market behavior and the disciplinary role of takeovers, I outline

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958 four areas for Austrian research in corporate governance: firms as investments,
959 internal capital markets, comparative corporate governance, and financiers as
960 entrepreneurs.

961 Limits of the Standard Approach to the Firm

962 As we saw in Chapter 1, the “firm” of economics textbooks is not really a firm at
963 all. The firm is treated as a production function or production possibilities set,
964 a “black box” that transforms inputs into outputs. While descriptively vacuous,
965 the production-function approach has the appeal of analytical tractability
966 along with its elegant parallel to neoclassical consumer theory (profit maxi-
967 mization is like utility maximization, isoquants are indifference curves, and so
968 on). Nonetheless, many economists now see it as increasingly unsatisfactory,
969 as unable to account for a variety of real-world business practices: vertical
970 and lateral integration, mergers, geographic and product-line diversification,
971 franchising, long-term commercial contracting, transfer pricing, research joint
972 ventures, and many others. The inadequacy of the traditional theory of the
973 firm explains much of the recent interest in agency theory, transaction cost
974 economics, the capabilities approach, and other facets of the “new institutional
975 economics.”¹ A more serious problem with the traditional theory, however,
976 has received less attention. The theory of profit maximization is nearly always
977 told from the perspective of the manager, the agent who operates the plant,
978 not that of the owner, who supplies the capital to fund the plant. Yet owners
979 control how much authority to delegate to operational managers, so capitalists
980 are the ultimate decision makers. To understand the firm, then, we must focus
981 on the actions and plans of the suppliers of financial capital.

982 Focusing on capital markets and the corporate governance problem high-
983 lights a fundamental analytical problem with the traditional approach to the
984 theory of the firm. In the production-function approach, money capital is
985 treated as a factor of production. The manager’s objective is to maximize
986 the difference between total revenues and total costs, with the cost of capital
987 treated simply as another cost (and typically assumed to be exogenous). The
988 residual, “profit,” is retained by the manager. Hence financial capital receives
989 scant attention. As discussed below, this can be a serious flaw.

990 Two Alternative Perspectives

991 What, then, is the proper way to understand the business firm? Two alternative
992 perspectives deserve consideration. The first perspective, which has received

¹The new institutional economics is reviewed and critiqued in Furubotn and Richter (1997), Klein (2000), Williamson (2000), Ménard and Shirley (2005) and Brousseau and Glachant (2008).

993 substantial attention in the Austrian literature, is that of the entrepreneur, or
994 what Mises (1949, p. 256) calls the “entrepreneur-promoter.” Entrepreneur-
995 ship, in the Misesian sense, is the act of bearing uncertainty. Production
996 unfolds through time, and thus the entrepreneur must purchase factors of
997 production in the present (paying today’s prices, which are known), in antic-
998 ipation of revenues from the future sale of the product (at tomorrow’s prices,
999 which are uncertain). Entrepreneurial profit or loss is the difference between
1000 these revenues and the initial outlays, less the general rate of interest. As such,
1001 profit is the reward for successfully bearing uncertainty. Successful promoters
1002 make accurate forecasts of future prices and receive returns greater than their
1003 outlays. Those whose forecasts are less accurate earn losses. Promoters who
1004 systematically make poor forecasts quickly find themselves unable to secure
1005 any further resources for investment and eventually exit the market.²

1006 The second perspective is that of the capitalist, the owner of the firm.
1007 Ownership can also be thought of as a factor of production—what Rothbard
1008 (1962, pp. 601–05) calls the “decision making factor”—but it is different from
1009 the other factors. In an ownership approach, money capital is treated as a
1010 unique factor of production, the “controlling factor”; the investor is both ulti-
1011 mate decision-maker and residual claimant. The firm’s objective is to maximize
1012 the return on the owner’s investment. Because the owner delegates certain
1013 functions to managers, a central focus of the theory of the firm becomes the
1014 problem of corporate governance: how do suppliers of capital structure their
1015 arrangements with managers in a way that maximizes their returns?

1016 This chapter argues that the most interesting problems in the theory
1017 of the firm relate to the intersection between the entrepreneurial function
1018 and the capitalist function. Indeed, as Mises argued, the driving force be-
1019 hind the market economy is a particular type of entrepreneur, the capitalist-
1020 entrepreneur, who risks his money capital in anticipation of future, uncertain,
1021 returns. Moreover, as discussed below, the entrepreneur is nearly always also
1022 a capitalist, and the capitalist is also an entrepreneur.

1023 Economists now increasingly recognize the importance of the capitalist
1024 in the direction of the firm’s affairs. In the introduction to his influential
1025 book *Strong Managers, Weak Owners*, Mark Roe (1994, p. vii) makes the point
1026 succinctly:

²Mises (1949, p. 254) defines the entrepreneurial function broadly, referring to “the aspect of uncertainty inherent in every action.” He quotes the English idiom: “There’s many a slip ‘twixt cup and lip” (p. 254). He defines entrepreneur-promoters more narrowly, as uncertainty-bearers “who are especially eager to profit from adjusting production to the expected changes in conditions, those who have more initiative, more venturesomeness, and a quicker eye than the crowd, the pushing and promoting pioneers of economic improvement.” He laments that the same word, “entrepreneurship,” has been used both for the general concept of uncertainty-bearing and the narrower role of the bold, active, creative, business person.

1027 Economic theory once treated the firm as a collection of machinery,
1028 technology, inventory, workers, and capital. Dump these inputs into a
1029 black box, stir them up, and one got outputs of products and profits.
1030 Today, theory sees the firm as more, as a management structure. The
1031 firm succeeds if managers can successfully coordinate the firm's activi-
1032 ties; it fails if managers cannot effectively coordinate and match people
1033 and inputs to current technologies and markets. At the very top of the
1034 firm are the relationships among the firm's shareholders, its directors,
1035 and its senior managers. If those relationships are dysfunctional, the
1036 firm is more likely to stumble.

1037 As Roe suggests, the relationships between the firm's owners (shareholders) and
1038 its top managers are centrally important in determining firm performance.³

1039 The Contractual Approach

1040 Both the entrepreneurial perspective and the ownership perspective can be
1041 understood from within the “contractual” framework associated with Coase
1042 (1937). In the Coasian framework, as developed and expanded by Williamson
1043 (1975, 1985, 1996), Klein, et al. (1978), Grossman and Hart (1986), Hart
1044 and Moore (1990), and others, the boundary of the firm is determined by
1045 the tradeoff, at the margin, between the relative transaction costs of external
1046 and internal exchange. In this sense, firm boundaries depend not only on
1047 technology, but on organizational considerations; that is, on the costs and
1048 benefits of various contracting alternatives.

1049 Moreover, economic organization, both internal and external, imposes
1050 costs because complex contracts are usually incomplete. The transaction-cost
1051 literature makes much of the distinction between complete and incomplete
1052 contracts. A complete contract specifies a course of action, a decision, or terms
1053 of trade contingent on every possible future state of affairs. In textbook models
1054 of competitive general equilibrium, all contracts are assumed to be complete.
1055 The future is not known with certainty, but the probability distributions of all
1056 possible future events are known.⁴ In an important sense, the model is “time-
1057 less”: all relevant future contingencies are considered in the *ex ante* contracting
1058 stage, so there are no decisions to be made as the future unfolds.

1059 The Coasian approach relaxes this assumption and holds that complete,
1060 contingent contracts are not always feasible. In a world of “true” (structural,
1061 rather than parametric) uncertainty, the future holds genuine surprises (Foss,
1062 1993a), and this limits the available contracting options. In simple transac-
1063 tions—for instance, procurement of an off-the-shelf component—uncertainty

³For surveys of the literature on corporate governance see Gilson (1996); Shleifer and Vishny (1997) and Zingales (1998).

⁴What Knight (1921) would describe as “risk,” rather than “uncertainty.”

1064 may be relatively unimportant, and spot-market contracting works well. For
1065 more complex transactions, such as the purchase and installation of special-
1066 ized equipment, the underlying agreements will typically be incomplete—the
1067 contract will provide remedies for only some possible future contingencies.⁵
1068 One example is a relational contract, an agreement that describes shared goals
1069 and a set of general principles that govern the relationship (Goldberg, 1980).
1070 Another is implicit contract—an agreement that while unstated, is presumably
1071 understood by all sides.⁶ Regardless, contractual incompleteness exposes the
1072 contracting parties to certain risks. In particular, investment in relationship-
1073 specific assets exposes agents to a potential “holdup” problem: if circumstances
1074 change, their trading partners may try to expropriate the rents accruing to the
1075 specific assets. Suppose an upstream supplier tailors its equipment to service
1076 a particular customer. After the equipment is in place, the customer may
1077 demand a lower price, knowing that the salvage value of the specialized equip-
1078 ment is lower than the net payment it offers. Anticipating this possibility, the
1079 supplier will be unwilling to install the custom machinery without protection
1080 for such a contingency, even if the specialized technology would make the
1081 relationship more profitable for both sides.

1082 One way to safeguard rents accruing to specific assets is vertical (or lateral)
1083 integration, where a merger eliminates any adversarial interests. Less extreme
1084 options include long-term contracts (Joskow, 1985, 1987, 1988, 1990), partial
1085 ownership agreements (Pisano, Russo, and Teece, 1988; Pisano, 1990), or
1086 agreements for both parties to invest in offsetting relationship-specific invest-
1087 ments (Heide and John, 1988). Overall, parties may employ several gover-
1088 nance structures. The Coasian literature tries to match the appropriate gover-
1089 nance structure with the particular characteristics of the transaction.⁷

1090 Building Blocks of an Austrian Theory of the Firm

1091 Beginning with the basic Coasian or contractual framework, we can add two
1092 elements as building blocks to an Austrian theory of the firm: entrepreneurship
1093 and economic calculation. Entrepreneurship represents the bearing of

⁵Williamson (1975, 1985, 1996) attributes contractual incompleteness to cognitive limits or “bounded rationality,” following Simon’s (1961, p. xxiv) interpretation of human action as “intendedly rational, but only limitedly so.” Other economists are more agnostic, assuming only that some quantities or outcomes are unobservable (or not verifiable to third parties, such as the courts), in which case contracts cannot be made contingent on these variables or outcomes.

⁶This is the sense in which Kreps (1990a) understands “corporate culture.”

⁷As noted in Chapter 1 above (pp. 15–17), some Austrians have questioned the Coasian, contractual approach as an appropriate basis for an Austrian theory of the firm. I do not share these concerns, however, seeing Coase’s framework as a general heuristic that can accommodate various notions of the *origins* of internal and external transaction costs, including those emphasized in the Austrian literature.

1094 uncertainty. Economic calculation is the tool entrepreneurs use to assess costs
1095 and expected future benefits. Consider each in turn.

1096 **Entrepreneurship**

1097 Entrepreneurship, in the Misesian sense, is the act of bearing uncertainty. In an
1098 ever-changing world, decisions must be made based on expectations of future
1099 events. Because production takes time, resources must be invested before the
1100 returns on those investments are realized. If the forecast of future returns is
1101 inaccurate, the expected profits will turn out to be losses. This is, of course,
1102 true not only of financial investors, but of all human actors. If the future were
1103 known with certainty, man would not act, since his action would not change
1104 the future. Thus, all purposeful human action carries some risk that the means
1105 chosen will not bring about the desired end. In this sense, all human actors
1106 are entrepreneurs.

1107 Austrians tend to focus on this kind of pure entrepreneurship, the entre-
1108 preneurial aspect of all human behavior. In doing so, however, they often
1109 overlook a particular case of entrepreneurship, the driving force behind the
1110 structure of production: the capitalist-entrepreneur, who risks his money cap-
1111 ital in anticipation of future events. Kirzner's (1973; 1979) influential inter-
1112 pretation of Mises identifies "alertness" or "discovery," rather than uncertainty
1113 bearing, as the defining property of entrepreneurship. In Kirzner's framework,
1114 entrepreneurial profit is the reward to superior alertness to profit opportunities.
1115 The simplest case is that of the arbitrageur, who discovers a discrepancy in
1116 present prices that can be exploited for financial gain. In a more typical case,
1117 the entrepreneur is alert to a new product or a superior production process and
1118 steps in to fill this market gap before others.

1119 Kirzner's formulation has been criticized, however, for a lack of atten-
1120 tion to uncertainty. According to this criticism, mere alertness to a profit
1121 opportunity is not sufficient for earning profits. To reap financial gain, the
1122 entrepreneur must invest resources to realize the discovered profit opportu-
1123 nity. "Entrepreneurial ideas without money are mere parlor games until the
1124 money is obtained and committed to the projects" (Rothbard, 1985, p. 283).
1125 Moreover, excepting the few cases where buying low and selling high are nearly
1126 instantaneous (say, electronic trading of currencies or commodity futures),
1127 even arbitrage transactions require some time to complete. The selling price
1128 may fall before the arbitrageur has made his sale, and thus even the pure
1129 arbitrageur faces some probability of loss. In Kirzner's formulation, the worst
1130 that can happen to an entrepreneur is the failure to discover an existing profit
1131 opportunity. Entrepreneurs either earn profits or break even, but it is unclear
1132 how they suffer losses.⁸

⁸See Chapter 5 below for further discussion of this point.

1133 Mises, by contrast, consistently identifies entrepreneurship with both
1134 profit and loss. “There is a simple rule of thumb to tell entrepreneurs from
1135 non-entrepreneurs. The entrepreneurs are those on whom the incidence of
1136 losses on the capital employed falls” (Mises, 1951, p. 112). Moreover, while
1137 Mises indeed acknowledges the element of entrepreneurship in all human
1138 action, it is clear that the potential losses of the capitalist-entrepreneurs are
1139 particularly important:

1140 Mises applies the concept of the entrepreneur to all cases of uncertainty-
1141 bearing, and since laborers face uncertainty in deciding where to move
1142 or what occupation to go into, laborers are also entrepreneurs. But the
1143 most important case of entrepreneurship, the driving force in shaping
1144 the actual structure and patterns of production in the market econ-
1145 omy, are the capitalist-entrepreneurs, the ones who commit and risk
1146 their capital in deciding when, what, and how much to produce. The
1147 capitalists, too, are far more subject to actual monetary losses than are
1148 the laborers. (Rothbard, 1985, p. 282)⁹

1149 Mises is careful to distinguish entrepreneurship from management, the
1150 carrying out of those tasks specified by the capitalist-entrepreneur. “[T]hose
1151 who confuse entrepreneurship and management close their eyes to the eco-
1152 nomic problem” (Mises, 1949, p. 704). It is the capitalist-entrepreneurs who
1153 control the allocation of capital to the various branches of industry.

1154 It is clear from this formulation that the capitalist-entrepreneur must
1155 own property. He cannot invest without prior ownership of financial capi-
1156 tal. (1871, pp. 159–61) treatment of production includes as entrepreneurial
1157 functions economic calculation, the “act of will,” and “supervision of the
1158 execution of the production plan.” These functions “entail property ownership
1159 and, therefore, mark the Mengerian entrepreneur as a capitalist-entrepreneur”
1160 (Salerno, 1999a, p. 30). Menger describes “command of the services of cap-
1161 ital” as a “necessary prerequisite” for economic activity. Even in large firms,
1162 although he may employ “several helpers,” the entrepreneur himself continues
1163 to bear uncertainty, perform economic calculation, and supervise produc-
1164 tion, even if these functions “are ultimately confined … to determining the
1165 allocation of portions of wealth to particular productive purposes only by
1166 general categories, and to selection and control of persons” (Menger, 1871,
1167 pp. 160–61; quoted in Salerno 1999a, p. 30).¹⁰ An Austrian theory of the
1168 firm, then, is essentially a theory about the ownership and use of capital. As
1169 Yu (1999, p. 7) puts it, “the Austrian firm is a collection of capital resources.”

⁹Of course, bondholders, as well as equity holders, are partly entrepreneurs, since even bondholders bear some default risk.

¹⁰For more on Misesian entrepreneurship and its various interpretations, see Chapter 5 below.

1170 Unfortunately, the Austrian literature on the firm often confuses entrepreneurship with innovation, strategic planning, leadership, and other functions
1171 more properly associated with management than ownership. Witt (1998),
1172 for example, describes entrepreneurship as a form of “cognitive leadership.”
1173 Witt outlines a potential Austrian theory of the firm by combining recent
1174 literature on cognitive psychology with Kirzner’s concept of entrepreneurship.
1175 Entrepreneurs require complementary factors of production, he argues, which
1176 are coordinated within the firm. For the firm to be successful, the entrepreneur
1177 must establish a tacit, shared framework of goals—what the management
1178 literature terms “leadership.” A proper Austrian theory of the firm, then, must
1179 take account of the ways in which entrepreneurs communicate their business
1180 conceptions within the organization.
1181

1182 The problem with this argument is that while organizational leadership is
1183 undoubtedly important, it is not particularly “entrepreneurial.” Entrepreneurship
1184 has little necessarily to do with having a business plan, communicating a
1185 “corporate culture,” or other dimensions of business leadership; these are at-
1186 tributes of the successful manager, who may or may not be an entrepreneur.¹¹
1187 Moreover, even if top-level managerial skill were the same as entrepreneurship,
1188 it is unclear why “cognitive leadership”—tacit communication of shared
1189 modes of thought, core capabilities, and the like—should be more entrepreneurial
1190 than other, comparatively mundane managerial tasks such as structuring
1191 incentives, limiting opportunism, administering rewards, and so on.

1192 Economic Calculation

1193 All entrepreneurs, particularly capitalist-entrepreneurs, use economic calculation
1194 as their primary decision-making tool. By economic calculation we simply
1195 mean the use of present prices and anticipated future prices to compare present
1196 costs with expected future benefits. In this way, the entrepreneur decides what
1197 goods and services should be produced, and what methods of production
1198 should be used to produce them. “The business of the entrepreneur is not
1199 merely to experiment with new technological methods, but to select from
1200 the multitude of technologically feasible methods those which are best fit to
1201 supply the public in the cheapest way with the things they are asking for most
1202 urgently” (Mises, 1951, p. 110). To make this selection, the entrepreneur must
1203 be able to weigh the costs and expected benefits of various courses of action.

1204 As discussed in the previous chapter, the need for economic calculation
1205 places ultimate limits on the size of the organization. Indeed, many writers

¹¹One distinction between entrepreneurship (as uncertainty bearing) and management is that managerial functions can be purchased on the market: innovation can be outsourced to R&D labs; strategic planning can be contracted out to consultants; corporate identities, both internal and external, can be developed and communicated by outside specialists; and so on.

1206 have recognized the connections between the socialist calculation debate and
1207 the problems of internal organization (Montias, 1976; Williamson, 1991c).
1208 Kirzner, for example, interprets the costs of internal organization in terms of
1209 Hayek's knowledge problem:

1210 In a free market, any advantages that may be derived from "central
1211 planning" ... are purchased at the price of an enhanced knowledge
1212 problem. We may expect firms to spontaneously expand to the point
1213 where additional advantages of "central" planning are just offset by the
1214 incremental knowledge difficulties that stem from dispersed informa-
1215 tion. (Kirzner, 1992, p. 162)

1216 What, precisely, drives this knowledge problem? The mainstream litera-
1217 ture on the firm focuses mostly on the costs of market exchange, and much
1218 less on the costs of governing internal exchange. The new research has yet to
1219 produce a fully satisfactory explanation of the limits to firm size (Williamson,
1220 1985, chap. 6). In Coase's words, "Why does the entrepreneur not organize
1221 one less transaction or one more?" Or, more generally, "Why is not all pro-
1222 duction carried on in one big firm?" (Coase, 1937, pp. 393–94). Existing con-
1223 tractual explanations rely on problems of authority and responsibility (Arrow,
1224 1974); incentive distortions caused by residual ownership rights (Grossman
1225 and Hart, 1986; Hart and Moore, 1990; Hart, 1995); and the costs of attempt-
1226 ing to reproduce market governance features within the firm (Williamson,
1227 1985, chap. 6). Rothbard (1962, pp. 609–16) offered an explanation for the
1228 firm's vertical boundaries based on Mises's claim that economic calculation
1229 under socialism is impossible. Rothbard argued that the need for monetary
1230 calculation in terms of actual prices not only explains the failures of central
1231 planning under socialism, but places an upper bound on firm size.

1232 Rothbard's account begins with the recognition that Mises's position on
1233 socialist economic calculation is not exclusively, or even primarily, about so-
1234 cialism, but about the role of prices for capital goods. Entrepreneurs allocate
1235 resources based on their expectations about future prices, and the information
1236 contained in present prices. To make profits, they need information about
1237 all prices, not only the prices of consumer goods but the prices of factors
1238 of production. Without markets for capital goods, these goods can have no
1239 prices, and hence entrepreneurs cannot make judgments about the relative
1240 scarcities of these factors. In any environment, then—socialist or not—where
1241 a factor of production has no market price, a potential user of that factor will
1242 be unable to make rational decisions about its use. Stated this way, Mises's
1243 claim is simply that efficient resource allocation in a market economy requires
1244 well-functioning asset markets. To have such markets, factors of production
1245 must be privately owned.

1246 Rothbard's contribution, described more fully in Chapter 1 above, was to
1247 generalize Mises's analysis of this problem under socialism to the context of

1248 vertical integration and the size of the organization. Rothbard writes in *Man, Economy, and State* that up to a point, the size of the firm is determined by
1249 costs, as in the textbook model. However, “the ultimate limits are set on the
1250 relative size of the firm by the necessity for markets to exist in every factor,
1251 in order to make it possible for the firm to calculate its profits and losses”
1252 (Rothbard, 1962, p. 599).

1253
1254 Consider, for example, a large, integrated firm organized into semi-autono-
1255 mous profit centers, each specializing in a particular final or intermediate
1256 product. The central management of the firm uses the implicit incomes of the
1257 business units, as reflected in statements of divisional profit and loss, to allo-
1258 cate physical and financial capital across the divisions. To compute divisional
1259 profits and losses, the firm needs an economically meaningful transfer price
1260 for all internally transferred goods and services. If there is an external market
1261 for the component, the firm can use that market price as the transfer price.
1262 Without a market price, however, the transfer price must be estimated, either
1263 on a cost-plus basis or by bargaining between the buying and selling divisions
1264 (Gabor, 1984; Eccles and White, 1988; King, 1994). Such estimated transfer
1265 prices contain less information than actual market prices.

1266 The use of internally traded intermediate goods for which no external mar-
1267 ket reference is available thus introduces distortions that reduce organizational
1268 efficiency. This gives us the element missing from contemporary theories of
1269 economic organization, an upper bound: the firm is constrained by the need
1270 for external markets for all internally traded goods. In other words, no firm can
1271 become so large that it is both the unique producer and user of an intermediate
1272 product; for then no market-based transfer prices will be available, and the firm
1273 will be unable to calculate divisional profit and loss and therefore unable to
1274 allocate resources correctly between divisions. Of course, internal organization
1275 does avoid the holdup problem, which the firm would face if there were a
1276 unique outside supplier; conceivably, this benefit could outweigh the increase
1277 in “incalculability” (Rothbard, 1962, p. 614). Usually, however, the costs from
1278 the loss of calculation will likely exceed the costs of external governance.¹²

1279 Like Kirzner (1992), Rothbard viewed his contribution as consistent with
1280 the basic Coasian framework, noting that his treatment of the limits of the
1281 firm “serves to extend the notable analysis of Professor Coase on the market
1282 determinants of the size of the firm, or the relative extent of corporate planning
1283 within the firm as against the use of exchange and the price mechanism. . . . The

¹²Similarly, Rothbard’s claim is not that because external prices are necessary for large firms to function efficiently, firms will tend to become large where external markets are “thick” or better developed. On the contrary, large firms typically arise precisely where external markets are poorly developed or hampered by government intervention; these are the kinds of circumstances that give entrepreneurs an advantage in coordinating activities internally (Chandler, 1977). However, such firms are still constrained by the need for some external market reference.

1284 costs of internal corporate planning become prohibitive as soon as markets for
1285 capital goods begin to disappear, so that the free-market optimum will always
1286 stop well short not only of One Big Firm throughout the world market but also
1287 of any disappearance of specific markets and hence of economic calculation in
1288 that product or resource" (Rothbard, 1976, p. 76). "Central planning" within
1289 the firm, then, is possible only when the firm exists within a larger market
1290 setting.

1291 Capital Markets

1292 If the capitalist-entrepreneur is the driving force behind the industrialized,
1293 market economy, then economists should focus their attention on the financial
1294 markets, the capitalist-entrepreneur's main venue. It is here that this most
1295 important form of entrepreneurship takes place. Of course, in the traditional,
1296 production-function theory of the firm, capital markets do little but supply
1297 financial capital to managers, who can get as much capital as they wish at the
1298 going market price. In a more sophisticated understanding, managers do not
1299 decide how much capital they want; capitalists decide where capital should
1300 be allocated. In doing so, they provide essential discipline to the plant-level
1301 manager, whom Mises (1949, p. 301) calls the entrepreneur's "junior partner."

1302 When capitalists supply resources to firms, they usually delegate to man-
1303 agers the day-to-day responsibility for use of those resources. Managers may
1304 thus be able to use those resources to benefit themselves, rather than the capi-
1305 talist. The problem of managerial discretion—what we now call the principal-
1306 agent problem—occupies much current research in the theory of the firm.
1307 Under what conditions can managers exercise discretionary behavior? What
1308 kinds of rules, or mechanisms, can be designed to align the manager's interest
1309 with the owner's? Without effective rules, what actions will managers choose?
1310 An early application was the proposed "separation of ownership and control"
1311 in the modern corporation. Berle and Means (1932) argued that the modern
1312 firm is run not by its owners, the shareholders, but by salaried managers, whose
1313 interests are different from those of shareholders and include executive perks,
1314 prestige, and similar rewards. If the corporation is diffusely held, no individual
1315 shareholder has sufficient motivation to engage in (costly) monitoring man-
1316 agerial decisions, and therefore discretion will flourish at the expense of the
1317 market value of the firm. However, Berle and Means did not consider how
1318 owners might limit this discretion *ex ante*, without the need for detailed *ex*
1319 *post* monitoring.

1320 Agency theory—now the standard language of corporate finance—ad-
1321 dresses these problems. As developed by Jensen and Meckling (1976); Fama
1322 (1980); Fama and Jensen (1983), and Jensen (1986), agency theory studies
1323 the design of *ex ante* incentive-compatible mechanisms to reduce agency costs

1324 in the face of potential moral hazard (malfeasance) by agents. Agency costs
1325 are defined by Jensen and Meckling (1976, p. 308) as the sum of “(1) the
1326 monitoring expenditures of the principal, (2) the bonding expenditures by the
1327 agent, and (3) the residual loss.” The residual loss represents the potential gains
1328 from trade that fail to be realized because perfect incentives for agents cannot
1329 be provided when the agent’s actions are unobservable. In a typical agency
1330 model, a principal assigns an agent to do some task (producing output, for
1331 instance), but has only an imperfect signal of the agent’s performance (for
1332 example, effort). The agency problem is analogous to the signal-extraction
1333 problem popularized in macroeconomics by Lucas (1972): how much of the
1334 observable outcome is due to the agent’s effort, and how much is due to
1335 factors beyond the agent’s control? The optimal incentive contract balances
1336 the principal’s desire to provide incentives to increase the agent’s effort (for
1337 example, by basing compensation on the outcome) with the agent’s desire to be
1338 insured from the fluctuations in compensation that come from these random
1339 factors.

1340 Owners of corporations (shareholders) use a variety of control or gov-
1341 ernance mechanisms to limit the managerial discretion described by Berle
1342 and Means. Both “internal” and “external” governance may be employed.
1343 Internally, owners may establish a board of directors to oversee the actions of
1344 managers. They can use performance-based compensation to motivate man-
1345 agers to act in the owners’ interest (for instance, giving managers stock options
1346 instead of cash bonuses). They can adopt a particular organizational form, such
1347 as the “M-form” structure, in which managerial discretion is more easily kept
1348 in check (Williamson, 1975). Finally, they can rely on competition within
1349 the firm for top-level management positions—what Fama (1980) calls the
1350 internal market for managers—to limit the discretionary behavior of top-level
1351 management.

1352 Even more important are external forces that help align managers’ interests
1353 with those of shareholders. Competition in the product market, for example,
1354 assures that firms whose managers engage in too much discretionary behavior
1355 will fail, costing the managers their jobs. In countries where universal bank-
1356 ing is permitted, large equity holders such as banks can exercise considerable
1357 influence over managerial behavior. The external governance mechanism that
1358 has received the most attention, however, is the market for ownership itself,
1359 the “market for corporate control.”

1360 Henry Manne’s essay, “Mergers and the Market for Corporate Control”
1361 (1965), responded to Berle and Means by noting that managerial discretion
1362 will be limited if there is an active market for control of corporations. When
1363 managers engage in discretionary behavior, the share price of the firm falls, and
1364 this invites takeover and subsequent replacement of incumbent management.
1365 Therefore, while managers may hold considerable autonomy over the day-

1366 to-day operations of the firm, the stock market places strict limits on their
1367 behavior.

1368 The central insight of Manne's paper is also found in Mises's *Human Action*
1369 (1949), in the passage distinguishing what Mises calls "profit management"
1370 from "bureaucratic management" (pp. 300–07). It is true, Mises acknowl-
1371 edges, that the salaried managers of a corporation hold considerable autonomy
1372 over the day-to-day operations of the firm. Nonetheless, the shareholders make
1373 the ultimate decisions about allocating resources to the firm, in their decisions
1374 to buy and sell stock:

1375 [The Berle–Means] doctrine disregards entirely the role that the capital
1376 and money market, the stock and bond exchange, which a pertinent
1377 idiom simply calls the "market," plays in the direction of corporate
1378 business.... [T]he changes in the prices of common and preferred
1379 stock and of corporate bonds are the means applied by the capitalists
1380 for the supreme control of the flow of capital. The price structure as
1381 determined by the speculations on the capital and money markets and
1382 on the big commodity exchanges not only decides how much capital
1383 is available for the conduct of each corporation's business; it creates a
1384 state of affairs to which the managers must adjust their operations in
1385 detail. (Mises, 1949, p. 303)

1386 Mises does not identify the takeover mechanism *per se* as a means for
1387 capitalists to exercise control—takeovers were much less popular before the
1388 late 1950s, when the tender offer began to replace the proxy contest as the
1389 acquisition method of choice—but the main point is clear: the true basis of the
1390 market system is not the product market, the labor market, or the managerial
1391 market, but the capital market, where entrepreneurial judgments are exercised
1392 and decisions carried out.

1393 Toward an Austrian Theory of Corporate Governance

1394 Given that financial-market entrepreneurship is the defining feature of a mar-
1395 ket economy, that economic calculation is the capitalist-entrepreneur's pri-
1396 mary tool, and that economic calculation requires well-functioning capital
1397 markets, what can capitalist-entrepreneurs do to govern their relationships
1398 with operational managers? What should be the basis of an Austrian theory of
1399 corporate governance? This section suggests four areas that Austrians should
1400 address: (1) the concept of the firm as an investment; (2) the relationship
1401 between internal and external capital markets; (3) comparative corporate gov-
1402 ernance; and (4) financiers as entrepreneurs. Consider each in turn.

1403 Firms as Investments

1404 Because the owner, and not the manager, is the ultimate decision-maker, the
1405 Austrian theory of the firm should comprise two elements: a theory of invest-
1406 ment (corporate finance), and a theory of how investors provide incentives
1407 for managers to use these resources efficiently (corporate governance). In
1408 microeconomics textbooks, by contrast, what the capital investors give to the
1409 firm is treated as just another factor of production. Its price, the “rental price
1410 of capital” or interest, is simply another cost to the producer. Any excess of
1411 revenues over costs, including the cost of capital, goes to the manager (some-
1412 times confusingly called the “entrepreneur”). This residual is called “profit,”
1413 though it is not profit in the Misesian sense.

1414 In the ownership perspective, as developed by Gabor and Pearce (1952,
1415 1958), Vickers (1970, 1987), Moroney (1972), and others, the firm is viewed
1416 as an investment. The firm’s goal is to maximize the return on invested capital.
1417 This money capital may be regarded as a factor of production, but it is a
1418 unique factor, the “controlling” factor that receives the net proceeds of the
1419 operation. Other factors, such as labor (including management) and physical
1420 capital, are regarded as “contracting” factors that receive a fixed payment. The
1421 services of the top-level manager are thus treated as a cost, while the investor
1422 is considered the residual claimant. Also note that because the capitalist bears
1423 the risk that the investment will fail, upon investing the capitalist has become
1424 an entrepreneur. Furthermore, to the extent that the entrepreneur (as Kirzne-
1425 rian discoverer) hires himself out to the capitalist as a salaried manager, his
1426 compensation is not entrepreneurial profit; it is a cost to the owner of the firm
1427 (Rothbard, 1985, p. 283). This has significant implications for firm behavior.
1428 First, the firm will not always expand output to the point where marginal
1429 revenue equals marginal cost. For if the firm is earning positive net returns
1430 at its current level of output, instead of increasing output until marginal net
1431 returns fall to zero, the firm could simply take those returns and employ them
1432 elsewhere, either to set up a new firm in the same industry or to diversify
1433 into a new industry (Gabor and Pearce, 1952, p. 253). The efficient scale of
1434 production is determined by outside investment opportunities, not simply the
1435 marginal returns from producing a single output.

1436 Indeed, it is easy to show that under fairly weak assumptions, the output
1437 level that maximizes the profit rate is less than the output level that maximizes
1438 the level of profit. Consider a standard, concave profit function; add a “money
1439 capital requirement,” the amount of capital required to finance a given level
1440 of output. As long as the money capital requirement is increasing in output,
1441 the output level that maximizes the profit rate—profit divided by the money
1442 capital required to finance that output level—is less than the output level that
1443 maximizes profit. From the capitalist’s perspective, output should be expanded

1444 to the point where the return on the last dollar of money capital is just equal
1445 to the opportunity cost of that last dollar of money capital. But as long as the
1446 plant manager is not free to invest his financial capital elsewhere, the manager's
1447 cost curves do not reflect this opportunity cost. Hence, the manager chooses
1448 a higher output level than that which maximizes the capitalist's return.

1449 Significantly, for internal accounting purposes, firms are typically struc-
1450 tured such that the goal of any operating unit is to maximize the return on its
1451 invested capital. In fact, not only do firms set up divisions as profit centers, as
1452 discussed above, but groups of profit centers are frequently grouped together
1453 as "investment centers" within the firm itself. Reece and Cool (1978) studied
1454 620 of the largest US firms in 1978 and found that seventy-four percent had
1455 investment centers. These subunits are commonly evaluated according to a
1456 return on a (ROI) criterion, such as the ratio of accounting net income gener-
1457 ated by the investment center divided by total assets invested in the investment
1458 center. More recently, measures such as residual income and "economic value
1459 added" (EVA) have become popular as an alternative to ROI (Stern, Stewart,
1460 and Chew, 1995). The point is that individual divisions are being evaluated
1461 on the same basis as the corporation itself—namely, what kind of return is
1462 being generated on the financial resources invested.

1463 Second, the firm-as-investment concept relates closely to an emerging lit-
1464 erature on merger as a form of firm-level investment (Bittingmayer, 1996;
1465 Andrade and Stafford, 2004). Once managers have acquired financial re-
1466 sources from capitalists, these managers have some discretion over how to
1467 invest those resources. To supplement the "normal" forms of firm-level invest-
1468 ment—capital expenditures and R&D—managers may choose to purchase
1469 assets of existing firms through merger. Merger may be a different form of
1470 investment; Andrade and Stafford (2004) find, for example, that mergers in
1471 particular industries tend to be clustered over time, while rankings of non-
1472 merger forms of investment by industry tend to remain constant. This suggests
1473 that merger activity is encouraged by specific industry or policy shocks, like
1474 deregulation, the emergence of junk-bond financing, and increased foreign
1475 competition (Mitchell and Mulherin, 1996). Nonetheless, mergers will be
1476 evaluated by the returns they generate, just like any other investment.

1477 Internal Capital Markets

1478 In his extension of the Coasian framework, Williamson (1975, 1981) describes
1479 the modern multidivisional or "M-form" corporation as a means of intra-firm
1480 capital allocation. Capital markets allocate resources between stand-alone,
1481 single-product firms. In the diversified, multidivisional firm, by contrast,
1482 resources are allocated internally, as the entrepreneur distributes funds among
1483 profit-center divisions. This "internal capital market" replicates the allocative

1484 and disciplinary roles of the financial markets, shifting resources toward more
1485 profitable lines of production.¹³ Coase claimed that firms “supplant” markets
1486 when the transaction costs of market exchange exceed those of internal pro-
1487 duction. Williamson adds that diversified, multidivisional firms “supplant”
1488 capital markets when the costs of external finance exceed those of internal
1489 resource allocation.

1490 According to the internal capital markets theory, diversified firms arise
1491 when limits in the capital market permit internal management to allocate and
1492 manage funds more efficiently than the external capital market. These effi-
1493 ciencies may come from several sources. First, the central headquarters of the
1494 firm (HQ) typically has access to information unavailable to external parties,
1495 which it extracts through its own internal auditing and reporting procedures
1496 (Williamson, 1975, pp. 145–47).¹⁴ Second, managers inside the firm may
1497 also be more willing to reveal information to HQ than to outsiders, since
1498 revealing the same information to the capital market would also reveal it to
1499 rival firms, potentially hurting the firm’s competitive position. Third, HQ
1500 can also intervene selectively, making marginal changes to divisional oper-
1501 ating procedures, whereas the external market can discipline a division only by
1502 raising or lowering the share price of the entire firm. Fourth, HQ has residual
1503 rights of control that providers of outside finance do not have, making it easier
1504 to redeploy the assets of poorly performing divisions (Gertner, Scharfstein,
1505 and Stein, 1994). More generally, these control rights allow HQ to add value
1506 by engaging in “winner picking” among competing projects when credit to
1507 the firm as a whole is constrained (Stein, 1997). Fifth, the internal capital
1508 market may react more “rationally” to new information: those who dispense
1509 the funds need only take into account their own expectations about the returns
1510 to a particular investment, and not their expectations about other investors’
1511 expectations. Hence there would be no speculative bubbles or waves.

¹³Such a process is described explicitly in the 1977 *Annual Report* of Fuqua Industries, a diversified firm with interests in lawn and garden equipment, sports and recreation, entertainment, photofinishing, transportation, housing, and food and beverages:

Fuqua’s strategy is to allocate resources into business segments having prospects of the highest return on investment and to extract resources from areas where the future return on investment does not meet our ongoing requirements. . . . The same principle of expanding areas of high return and shrinking areas of low return is constantly extended to product lines and markets within individual Fuqua operations. Only with a diversified business structure is the application of this modern fundamental business investment policy practical.

Another highly diversified firm, Bangor Punta Corporation, explains that the role of its corporate headquarters is “to act as a central bank supplying operating units with working capital and capital funds” (1966 *Annual Report*).

¹⁴Myers and Majluf (1984) show that if the information asymmetry between a stand-alone firm and potential outside investors is large enough, the firm may forego investments with positive net present value rather than issue risky securities to finance them.

1512 Bhidé (1990) uses the internal capital markets framework to explain both
1513 the conglomerate merger wave of the 1960s and the divestitures of the 1980s,
1514 regarding these developments as responses to changes in the relative efficiencies
1515 of internal and external finance. For instance, corporate refocusing can be
1516 explained as a consequence of the rise of takeover by tender offer rather than
1517 proxy contest, the emergence of new financial techniques and instruments like
1518 leveraged buyouts and high-yield bonds, and the appearance of takeover and
1519 breakup specialists, like Kohlberg Kravis Roberts, which themselves performed
1520 many functions of the conglomerate HQ (Williamson, 1992). Furthermore,
1521 the emergence of the conglomerate in the 1960s can itself be traced to the
1522 emergence of the M-form corporation. Because the multidivisional structure
1523 treats business units as semi-independent profit or investment centers, it is
1524 much easier for an M-form corporation to expand via acquisition than it is for
1525 the older unitary structure. New acquisitions can be integrated smoothly when
1526 they can preserve much of their internal structure and retain control over day-
1527 to-day operations. In this sense, the conglomerate could emerge only after the
1528 multidivisional structure had been diffused widely throughout the corporate
1529 sector.

1530 Internal capital market advantages, then, explain why diversification can
1531 increase the value of the firm. During the 1960s, entrepreneurs took advantage
1532 of financial-market imperfections (many due to regulatory interference) to
1533 form large, highly diversified firms (Hubbard and Palia, 1999; Klein, 2001).
1534 They also benefited from government spending in high-technology and other
1535 defense-related businesses, which were particularly suited for acquisition. In
1536 the two subsequent decades, financial-market performance improved, reduc-
1537 ing the internal capital market advantages of conglomerate firms.

1538 If entrepreneurs have a special ability to manage information and allocate
1539 financial resources within the firm—if diversified firms “supplant” external
1540 capital markets—then why are capital markets necessary at all? Why not, to
1541 paraphrase Coase’s (1937, pp. 393–94) second question, organize the entire
1542 economy as one giant conglomerate? The answer is that the argument for
1543 internal capital market advantages does not “scale up”; it applies only to firms
1544 that are themselves engaged in rivalrous competition. This situation, in turn,
1545 implies strict limits to firm size, even for large conglomerates.

1546 The argument for the efficiency of internal capital markets is that com-
1547 pared with outside investors, the entrepreneur can extract additional informa-
1548 tion about divisional requirements and performance. It is not that the entre-
1549 preneur’s knowledge substitutes for the knowledge embodied in market prices.
1550 To evaluate the merit of a proposed investment, the central management of
1551 a diversified conglomerate still relies on market prices to calculate expected
1552 (money) benefits and cost. Internal accounting does not substitute for money
1553 prices; it merely uses the information contained in prices in a particular way.

1554 When capital-goods prices are distorted—for example, because of financial
1555 market regulation—then the entrepreneur’s additional knowledge is that much
1556 more valuable. So under those conditions we would expect an increase in M-
1557 form corporations, allocating resources via internal capital markets. During
1558 the 1960s, that is exactly what we observed.

1559 Correctly understood, the internal capital markets hypothesis does not
1560 state that internal capital markets supplant financial markets. It states that
1561 internal capital markets supplement financial markets. Even ITT’s Harold
1562 Geneen, LTV’s James Ling, Litton’s “Tex” Thornton, and the other conglomer-
1563 ators of the 1960s were constrained by the need for economic calculation in
1564 terms of money prices. Thornton’s “Whiz Kids” have been criticized for their
1565 advocacy of “scientific management” or “management by the numbers.” Yet
1566 Thornton’s techniques were quite successful at Litton. It was only when his
1567 disciple Robert McNamara tried to apply the same techniques to a nonmarket
1568 setting—the Vietnam War—that the limitations of “scientific management”
1569 were revealed.¹⁵

1570 Comparative Corporate Governance

1571 How well do various systems of corporate governance function? The last few
1572 years have seen the growth of a new literature on “comparative corporate
1573 governance,” the study of alternative means of governing relations between
1574 firm owners and managers. The typical comparison is between stock-market
1575 systems like those in the US and UK, and bank-centered systems like those in
1576 Germany and Japan (Roe, 1994; Gilson and Black, 1998; Milhaupt, 1997).
1577 According to Roe, the phenomenon he calls “strong managers, weak owners”
1578 is an outgrowth not of the market process, but of legal restrictions on firm
1579 ownership and control. In the US, for example, banks and other institutions
1580 are forbidden from owning firms; antitrust laws prohibit industrial combi-
1581 nations like the Japanese keiretsu; and anti-takeover restrictions dilute the effects
1582 of the takeover mechanism. Laws that require diffuse ownership create what
1583 Roe terms the “Berle–Means corporation,” in which “fragmented ownership
1584 shifts power in the firm to managers” (p. 93).

1585 Mises makes a very similar argument in *Human Action*. There he notes that
1586 “the emergence of an omnipotent managerial class is not a phenomenon of
1587 the unhampered market economy,” but a result of government policy (Mises,
1588 1949, p. 304). Here he expands upon his earlier analysis in *Bureaucracy* (1944,
1589 p. 12), where he attacks the claim that bureaucracy follows naturally from
1590 firm size. Mises conceives of bureaucracy as rule-following, as opposed to
1591 profit-seeking, behavior. He reserves the term “bureaucratic management” for

¹⁵For more on the relationship between Thornton and McNamara, see Shapley (1993), and Byrne (1993).

1592 the governing of activities that have no cash value on the market. As long
1593 as a firm's inputs and outputs are bought and sold, the central management
1594 of the firm will have the information provided by market prices to evaluate
1595 the efficiency of the various branches and divisions within the firm. Then
1596 subordinate managers can be given wide discretion to make daily operational
1597 decisions without the pursuit of profit.¹⁶ If an organization produces a good
1598 or service that has no market price—the output of a government agency, for
1599 example—then subordinate managers must be given specific instructions for
1600 how to perform their tasks.

1601 The fact that managers in a private firm have latitude to make day-to-day
1602 decisions, Mises argues, does not make the firm "bureaucratic." "No profit-
1603 seeking enterprise, no matter how large, is liable to become bureaucratic pro-
1604 vided the hands of its management are not tied by government interference.
1605 The trend toward bureaucratic rigidity is not inherent in the evolution of
1606 business. It is an outcome of government meddling with business" (Mises,
1607 1944, p. 12). By this Mises means that government interference impedes the
1608 entrepreneur's use of economic calculation and the attempt to use prices to
1609 impose managerial discipline. Mises gives three examples (pp. 64–73): taxes
1610 and price regulations that interfere with corporate profits (distorting an im-
1611 portant signal of managerial performance); laws that interfere with hiring and
1612 promotion (including the need to hire public relations staffs and legal and ac-
1613 counting personnel to comply with government reporting requirements); and
1614 the omnipresent threat of arbitrary antitrust or regulatory activity, in response
1615 to which entrepreneurs must become adept at "diplomacy and bribery" (p. 72).
1616 Absent such legal restrictions, Mises would argue, managerial autonomy is
1617 no inefficiency; it's an essential tool for operating a large, decentralized orga-
1618 nization. But the firm must have accurate divisional accounting statements
1619 to evaluate managerial performance, and for this it needs the information
1620 contained in market prices.

1621 Financiers as Entrepreneurs

1622 As mentioned above, much current research in the theory of the firm fo-
1623 cuses on the agency problem. Under what conditions can managers exer-
1624 cise discretionary behavior? What kinds of rules, or mechanisms, can be de-
1625 signed to align the manager's interest with the owner's? Without effective

¹⁶Chapter 1 of *Bureaucracy*, on profit management and the sources of entrepreneurial profit, contains a remarkably lucid account of economic calculation under capitalism and its impossibility under socialism. "To the entrepreneur of capitalist society a factor of production through its price sends out a warning: Don't touch me, I am earmarked for another, more urgent need. But under socialism these factors of production are mute" (Mises, 1944, p. 29). Mises also provides a very Coase-like discussion of the make-or-buy decision, though without citation (p. 33).

rules, what actions will managers choose? Mises was well aware of the agency problems, or conflicts of interest, that emerge in organizations (e.g., Mises, 1944, pp. 42–47). But, as we have seen, he saw the firm's owner or owners as playing the primary entrepreneurial role, and paid special attention to the mechanisms available to owners to limit this discretion. Financiers, acting in stock and bond markets—writing today, Mises would probably have discussed private-equity markets as well—are the large firm's ultimate decision-makers. Rothbard (1962, p. 602) puts it this way:

Hired managers may successfully direct production or choose production processes. But the ultimate responsibility and control of production rests inevitably with the owner, with the businessman whose property the product is until it is sold. It is the owners who make the decision concerning how much capital to invest and in what particular processes. And particularly, it is the owners who must choose the managers. The ultimate decisions concerning the use of their property and the choice of the men to manage it must therefore be made by the owners and by no one else.

Kirzner (1973, p. 68) makes a similar point about alertness: it can never be fully delegated. “It is true that ‘alertness’ . . . may be hired; but one who hires an employee alert to possibilities of discovering knowledge has himself displayed alertness of a still higher order. . . . The entrepreneurial decision to hire is thus the ultimate hiring decision, responsible in the last resort for all factors that are directly or indirectly hired for his project.” Kirzner goes on to quote Knight (1921, p. 291): “What we call ‘control’ consists mainly of selecting someone else to do the ‘controlling.’ ”

Significantly, Mises's treatment of the importance of financial markets is key to his final rebuttal in *Human Action* to Lange, Lerner, and the other market-socialist critics of his calculation argument (Mises, 1949, pp. 694–711). The market socialists, he argued, fail to understand that the main task performed by a market system is not the pricing of consumer goods, but the allocation of capital among various branches of industry. By focusing on production and pricing decisions within a given structure of capital, the socialists ignore the vital role of capital markets. Rothbard (1993) notes that the same criticism can be applied to the textbook, production-function model of the firm, where capital is also taken for granted. “Neoclassical microtheory talks about ‘managers’ producing up to the point where $MR = MC$, without ever talking about who or what is allocating capital to them. In short, neoclassical firms are implicitly assumed to have a fixed amount of capital allocated to them . . . and they can only use that capital to invest in their own firm and nowhere else. Hence, the nonsensical conclusion that each firm’s manager will try to squeeze out the last cent of profit, pushing production until $MR = MC$.” Fortunately, the new literature on transaction-cost determinants of contractual

1668 relations has begun to bring capital back into the received microtheory.

1669 Failure to understand the entrepreneurial role of capital providers plagues
1670 the mainstream literature in corporate finance and corporate control. For
1671 example, there is considerable debate about the effectiveness of the takeover
1672 mechanism in providing managerial discipline. If managers desire acquisi-
1673 tions to increase their own prestige or span of control—to engage in “empire
1674 building”—then an unregulated market will generate too many takeovers.
1675 Merger critics such as Ravenscraft and Scherer (1987), discussed in chapter 3
1676 below, support increased restrictions on takeover activity. Jensen (1986, 1993)
1677 suggests changes in the tax code to favor dividends and share repurchases over
1678 direct reinvestment, thus limiting managers’ ability to channel free cash flow
1679 into unproductive acquisitions.

1680 However, the fact that some mergers—indeed, many mergers, takeovers,
1681 and reorganizations—turn out to be unprofitable does not imply market fail-
1682 ure or necessarily prescribe any policy response. Errors will always be made
1683 in a world of uncertainty. Even the financial markets, which aggregate the
1684 collective wisdom of the capitalist-entrepreneurs, will sometimes make the
1685 wrong judgment on a particular business transaction. Sometimes the market
1686 will reward, *ex ante*, a proposed restructuring that has no efficiency rationale.
1687 But this is due not to capital market failure, but to imperfect knowledge. Final
1688 judgments about success and failure can be made only *ex post*, as the market
1689 process plays itself out. Moreover, there is no reason to believe that courts or
1690 regulatory authorities can make better judgments than the financial markets.
1691 The decisions of courts and government agencies will, in fact, tend to be far
1692 worse: unlike market participants, judges and bureaucrats pursue a variety of
1693 private agendas, unrelated to economic efficiency. Furthermore, the market
1694 is quick to penalize error as it is discovered; no hearings, committees, or fact-
1695 finding commissions are required. In short, that firms often fail is surprising
1696 only to those committed to textbook models of competition in which the very
1697 notion of “failure” is defined away.

1698 Another criticism of the market for corporate control is that unregulated
1699 financial markets engage in too few takeovers, due to a free-rider problem
1700 associated with tender offers (see, for example, Scharfstein 1988). Critics
1701 point out that if the difference between the current (undervalued) price of the
1702 firm and its after-takeover market value is common knowledge, then the target
1703 firm’s shareholders will refuse to tender their shares until the current price is
1704 bid up, appropriating a share of the returns to the acquiring firm. These critics
1705 conclude that regulation, not the takeover market, should be used to discipline
1706 managers.

1707 The flaw in this argument is that it assumes perfect knowledge on the
1708 part of investors. The typical shareholder will not usually have the same in-
1709 formation as incumbent managers, outside “raiders,” and other specialists. It

1710 is not in the small shareholder's interest to learn these details; that is why he
1711 delegates such responsibilities to the managers in the first place. As Hayek
1712 (1945) described it, there is a "division of knowledge" in society. The raider
1713 who perceives and exploits a difference between a firm's current market value
1714 and its potential value under new management has an opportunity for an
1715 entrepreneurial profit (less the transaction costs of takeover). Because share-
1716 holders have delegated these responsibilities, they will not usually earn a share
1717 of this profit. Nonetheless, as explained above, because shareholders (owners)
1718 choose to delegate operational responsibility to managers—contracting out for
1719 the managerial function—they themselves retain the ultimate rights of control.

1720 Moreover, the post-takeover market value of the firm is uncertain; the
1721 raider's profit, if he is successful, is the reward for bearing this uncertainty.
1722 In this sense, the takeover artist is a Misesian capitalist-entrepreneur. This
1723 account, however, could use further elaboration. For example, how is the
1724 bearing of uncertainty distributed among participants in various forms of re-
1725 structuring? How do regulatory barriers hamper the capitalist-entrepreneur's
1726 ability to exercise the entrepreneurial function in this context?

1727 Conclusions

1728 The main message of this chapter is that Austrians can continue to work within
1729 the contractual, or Coasian, approach to the firm in elaborating the insights
1730 discussed above. In particular, the problem of corporate governance, and the
1731 corollary view that firms are investments, belongs at the forefront of Austrian
1732 research on the theory of the firm. Emphasis should thus be placed on the
1733 plans and actions of the capitalist-entrepreneur.

1734 A particularly undeveloped area concerns the provision of capital to small,
1735 "entrepreneurial" ventures. Most of the literature on governance focuses on
1736 the large corporation, and the use of stock and bond markets to govern these
1737 organizations. Equally important, however, are smaller, privately held firms,
1738 financed with venture capital or other forms of investment. So far, the firm-
1739 as-investment literature has said little about these organizations, despite their
1740 growing importance, particularly in high-growth, technologically-advanced
1741 industries like software and biotechnology. Further research in this area is
1742 sorely needed.