Foreword

Economists have regarded the market as a decentralized system of resource allocation for a long while. In the market, no one is in charge of allocating resources beyond what every individual has under his or her command. For instance, there is no one centrally deciding whether car makers should produce white cars or whether computer makers should make laptops rather than desktop computers. In such a system, entrepreneurs constantly bid resources away from their current uses in order to reallocate them towards what consumers may want to buy. In the marketplace, resources are bought and sold without anyone deciding what the overall allocation of resources should look like.

The opposite is true in business firms – or so it seems. Indeed, the traditional story is to say that firms are islands of planning and hierarchy in the sea of the market. For years, firms’ internal structures were not a subject of inquiry. Economists assumed they were centralized hierarchies because in economic theory firms were nothing more than production functions. Things started to change in the 1960s with, for instance, the work of Alfred Chandler, which looked at the inside of the black box to discover that firms can have some degree of decentralization. Progressively economists started paying more and more attention to the inner structure of firms and the role of hierarchy. More specifically, the idea that hierarchy may be an impediment to firm development has become a subject of inquiry in recent years with the emergence of corporations with flattened structures. Many management articles and books, as well as economics ones, have been written on the subject.

It is in this context that Dr Pongracic offers the economics profession remarkable research into the causes of organizational change and the rationales for firms’ structural evolution. It draws on the economics of organizations, entrepreneurship theory, and the insights from, among others, Joseph Schumpeter and Friedrich Hayek. It also draws on other disciplines to explain phenomena within the firm that economists have not been able to fully account for. Dr Pongracic’s book is not intended to dispense advice to managers; it is about studying the causes as to why some firms flatten their hierarchical structure and decentralize while others don’t. And as economists have discovered over the last few decades, firms’ structural changes don’t occur without their share of difficulties, among them opportunistic behavior and agency problems.

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Yet, for some economists, an even more important issue exists. The major problem that economics must explain is that of the co-ordination of knowledge and resources. Ludwig von Mises warned that no central planning exercise can solve the co-ordination problem absent market prices and private property. Because firms rely to a great extent on centralization and hierarchies (and not on actual market prices), they face an internal co-ordination problem, which worsens as they grow.

A potential solution is to introduce high-powered incentives similar to what one finds in markets. Flattening the hierarchy and decentralizing decision-making are two main avenues to introduce those market-like incentives. However, absent real prices, internal co-ordination may remain a difficulty. Countless studies have shown how firms can use shadow prices to reveal the opportunity costs of using internal resources and how intrapreneurs can take advantage of them. Still, these studies rarely focus on the existence of other (entrepreneurially driven) mechanisms that would solve the internal co-ordination problem (as well as problems of opportunism and agency). A flattened hierarchy and a more decentralized structure may bring about processes that go a long way towards (paradoxically perhaps) creating a greater internal co-ordination and making some firms more entrepreneurial. This is where Dr Pongracic’s fresh perspective on the subject offers new insights. He skillfully presents an original approach arguing for the presence of non-price co-ordinative mechanisms within firms with a flattened hierarchy. He explains why, under certain circumstances, firms can introduce strong entrepreneurial incentives and market-like structures without dissolving into chaos.

Scholars in the area of management as well as Austrian economists and specialists of the theory of the firm will find important insights in this book. Dr Pongracic doesn’t fall into the trap of arguing that decentralization is the new big thing that every CEO should be thinking about. He simply consistently applies the approach of Austrian economics and other disciplines to explain firms’ structural changes. Dr Pongracic’s book is a major contribution to our understanding of why firms do what they do and it provides a way for concepts developed in the Austrian literature to have a voice in the larger debate. We can only be grateful to him for all that.

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February 2008