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AUSTRIAN ECONOMICS, DYNAMIC FITTING AND ORGANIZATIONAL STUDIES IMPLICATIONS

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ABSTRACT

Austrian economics is a disequilibrium-based understanding of how firms interact in markets. Using basic concepts from Austrian economics and the market dynamics implied from them, this paper presents a dynamic view of fitting as one of the implications for organization studies and highlights other critical areas including entrepreneurship, innovation, information processing and organizational learning and change.

INTRODUCTION

"Fit" has been a long time central focus in the strategy and contingency literatures (Summer et al. 1990; Van de Ven & Drazin, 1985). Measuring fit has been harder. Doty et al., (1993) utilizes the fit perspective of measuring the distance of a firm from an ideal type, while others measure a firm's Euclidean distance from the best performer within a particular environmental niche, thus implying that the best performer is in best fit. Generally fit is conceptualized as *a specific end-goal implying an attainable fit is possible*. This implies clear links between cause and effect (otherwise fit could not be the specific end goal), conditions present in the environment will continue (otherwise what is useful not may not be in the future) and the use of negative feedback enables the determination of the set of requirements needed for fit (otherwise the distance from any specified set of requirements is useless). These assumptions describe an equilibrium-based market economy (Stacey, 1995).

Recently the usefulness of the foundational assumptions of equilibrium-based economics have been questioned, and an alternative presented that suggests the use of disequilibrium-based economic system, Austrian economics (Scarh, 1988; Stacey, 1995). Such a system contributes to complexity (Stacey, 1995) with assumptions that causal links are curvilinear, results are partially planned and partially emergent, and specific predictions of outcomes are problematic. This means that fit become an apparition that organizations chase, and that there are only "degrees" of fit. At any point in time, an organization may only be in "better" or "worse" fit. This implies that the search for fit, or the fitting process, is key. This paper presents the dynamics of the fitting process in a complex system based on the underlying explanation provided by Austrian economics. It finishes with outlining some critical areas of research arising from exploring a disequilibrium-based understanding of market forces.

AUSTRIAN ECONOMICS ASSUMPTIONS AND FOUNDATIONS

Uncertainty

Austrian economics expects that ex ante plans will not necessarily be realized and so is based on the concept of uncertainty. However, the economic agent inherently copes with this uncertainty (Kirzner, 1982; Mises, 1949). Mistakes, inefficiencies and even failure happens but their occurrence is not the same thing as irrationality (Mises, 1957). This view accords all action as being future oriented (Kirzner, 1978).

If people pursue purposes linked to the future, they will act to place themselves in the most preferred of equally available positions (Kirzner, 1978). If that positioning fails, then the successful position was either not available (attributable to an error in judgement; Kirzner, 1978), the economic agent was not aware of the successful position (attributable to an error in collecting information; March and Simon, 1992), or the environment shifted changing the definition of a successful positions (attributable to emergent or unpredicted systemic change; Mintzberg & Waters, 1984; Stacey, 1995). The second case requires further elaboration. Even though the agent was not aware that the information was available, it is an example of the economic error of not acting upon information. The existence of the element of unawareness is not impossible (as assumed in rational expectations in the Keynesian view; Scarh, 1988) because purposeful action by itself does not guarantee that every opportunity be instantaneously perceived (Kirzner, 1978). Purposeful action seeks out available opportunities (O'Driscoll, 1977). It is absurd to expect that all individuals perceive the same information in the same way, react in the same way, or form the same expectations (Lachmann, 1977).

A key issue in purposeful action is the acquisition and dispersal of knowledge (information) because it enables the management of the uncertainty inherent in any purposeful action which addresses the future. Thus to the Austrian economist, the market is a "process of learning and discovery, rather than an equilibrium state of affairs" (Klein, 1992:2). The market assumption is "not on human rationality, but on human ignorance" (Klein, 1992:4). Information is assumed to never be fully dispersed nor completely utilized.

Entrepreneurs

Each individual's acts are a speculation on the future, so there is an inherent link between entrepreneurial activities and human action (Mises, 1949). Entrepreneurial activities are defined as the function of making decisions and taking actions in the face of an uncertain present or future environment and the realization of existing opportunities that have remained previously unnoticed (Kirzner, 1982). Since it is reasonable to assume that the purposeful person is acting upon his imagined future (Mises, 1949) and that his actions impact the actual future (Giddens, 1979), the closer his imagined future is to the actual, the more successful his plans (Kirzner, 1978). An individual's motivation to imagine a future as close to actuality as possible is the desire for the rewards generated by the successful completion of his plans.

Entrepreneurial alertness is the scanning of the environment and the interpreting of it to construct that envisioned future (Kirzner, 1982). This does not stop seeing what is unfolding and reacting to it, but includes taking a proactive stance such as imaginative and creative leaps of faith that can result in the creation of the imagined future for which his present acts were designed (the alignment of the imagined future with the actual future to the entrepreneur's actions). This implies that the search for entrepreneurial activity is provided by the uncertainty of the future and that the use of entrepreneurial alertness is rewarded by the increased success of the entrepreneur's plans (Kirzner, 1982).

At the market level, the entrepreneur's function is to coordinate different parts of the market into coordination with each other" (Kirzner, 1982: 136). It is this coordinating and fitting process that keeps the disequilibrium of the market from total divergence. The degree of

which the market is in equilibrium depends upon the strengths of the entrepreneur's activities (Griner, 1977). The obtaining of any one market equilibrium reduces the opportunity for entrepreneurial activity in that particular market (Kirzner, 1979).

The Marketplace and Disequilibria

In the Austrian school's perspective, the concept of market equilibrium is a reflection of the coordination process. The driving elements in this setting are the entrepreneurial decisions and activities (Kirzner, 1979) and the diffusion of the knowledge revealed and created by the entrepreneurial activity (Lachmann, 1977).

This entrepreneurial seeking, collecting, acting upon and disseminating of knowledge results in a model that is based on a capital stock that is heterogeneous and which is integrated into a structure of production (Garrison, 1978). Thus the capital structure of any firm within the market is not assumed to be a miniature replication of the market. Entrepreneurs create the combination of the elements of the capital structure (Lachmann, 1977). These structures may be reshuffled as entrepreneurs realize better uses for their resources. Their economic returns may be eroded as competition increases due to the other entrepreneurs' choice to compete based on their being aware of the opportunity represented by the resource combination due to their alert scanning of the environment.

Although the entrepreneurs attempt coordination efforts, they are thwarted in the achieving of those efforts time and time again by the dissemination of knowledge, the inflow of new knowledge (technology changes, changes in human social tastes), and also in part "from the spontaneous action of the alert minds of participants inspired, but not compelled, by what they witness on the market scene around them" (Lachmann, 1977: 40). With this perspective, the market place is not characterized by a state of equilibrium but rather by a series of disequilibria that as information is shared moves closer to states of equilibria (Kirzner, 1982). Economic rents are probable in this disequilibrium-based market.

IMPLICATIONS FROM EQUILIBRIUM VERSUS DISEQUILIBRIUM-BASES EQUILIBRIUM FOCUSES

In an equilibrium-based system such as classical economics, the system is viewed as having a "center of gravity" to which prices gravitate, and equilibrium point (Addleson, 1994). At the equilibrium point, only enough profits are earned to reward the investor's expectation of return and allow firm survival. When the assumptions of classical economics are relaxed, rents (or excess profits) can be earned only when there are barriers to keep this inevitable "gravity" from happening. Several types of potential blockages and their attendant higher than "normal" returns have been identified in the past (Monopoly, Ricardian, Pareto-Marshall, and Pareto rents; Peteraf, 1993).

Ricardian, Pareto-Marshall, and Pareto rents are earned in existing markets and are due either to superior resources (Ricardian), to better use of the resources in the firm than generally known in the market place (Pareto-Marshall), or to efficiencies (Pareto) in the use of the resources (Peteraf, 1993). Attempts to understand these rents and how they are generated and their strategic use has lead researchers to develop Transaction Cost economics, Agency theory, among others. These are perfectly appropriate theoretical orientations given the basis in an equilibrium understanding of the market and have provided useful viewpoints and increased our understanding of organizations and why certain decisions may be made in these conditions. However as presented earlier, this equilibrium view appears to be less useful in

attempting to understand today's market characteristics and critical issues.

Disequilibrium Forces

In Austrian economics, the market is in a state of disequilibrium, which provides opportunities to earn a variety of rents. These rents are similar to the rents possible in neoclassical economics but also including Entrepreneurial rents or E-rents. Entrepreneurial rents (E-rents) occur when a firm or entrepreneur enters or creates a previously unknown or unused competitive arena or market (Peteraf, 1993) and attempts to coordinate the market factors (Lachmann, 1977). While both entrepreneurial and monopoly rents are due to a restriction in competition by firms, E-rents differ from monopoly rents in the lack of the previous identification of the competitive arena and in the lack of deliberate restriction of output. E-rents are the entrepreneur's reward for taking on the risk of market coordination. This risk is associated with creating the initial market structure (which is assumed to be in place in equilibrium systems but not disequilibrium-based systems).

How are rents earned in this disequilibrium-based system? Rents are not necessarily earned through the creation of "barriers" but through the very dynamics of the disequilibrium system. For example, if better performance occurs because a firm has a relatively better fit with the competitive environment (due to the entrepreneurial activities), then the earning of rents occurs because the firm attains a better fit than is anticipated by the market (due to inadequate information diffusion). Because of the lack of information, the complete set of fit requirements is not entirely known (see Austrian economics discussion earlier), a variety of such *better-fit* surprises can occur; which, therefore, enables multiple firms to generate rent.

However, with the generation of rents additional aspects of a current set of fit requirements are revealed. As the information about the returns available for any given fit is dispersed throughout the market place, potential competitors have access to the information. As firms choose to enter the revealed market (thereby utilizing the dispersed information), the density of firms in the market increases (Kirzner, 1982). It is this increased density coupled with a more complete diffusion of information about the market that enables each rent earned to be competed away. When there is increased market activity with a more complete diffusion of information, market dynamics are shifted to one that more closely resembles an equilibrium-based market. Given the inherent limits in noticing, gathering, interpreting, judging and utilizing information (March & Simon, 1992) and the entrepreneurial alertness described earlier (Kirzner, 1982), the choice to enter or exit particular product markets is a result of the information use of entrepreneurs. Thus the driving force behind the rent cycle is the diffusion and use of information.

It is interesting to note that the fit at the market level is inversely related to the fit at the firm level. The achievement of rents reveals that a relatively good fit for an individual firm has occurred. Yet, when the level of analysis is changed to the market, the earning of rents indicates that the degree of fit across all organizations is still relatively poor. The erosion of rents indicates that there is convergence on a particular fit and indicates a better overall degree of fit in the market. This provides further support for fit being relative not absolute. The organization that earns rents has the relatively better degree of fit.

Because rents are higher than normal returns, firms attempt to earn them. Once earned and revealed to the competitive arena, the potential exists for what once conferred an advantage to become simply a needed element for competition (see above discussion of diffusion

of information and also Barney, 1991). If others utilize the revealed information, the initial firm's fit as revealed by market performance may worsen. The "lower than previous times" returns spark a reevaluation and potential modification of fit by that initial firm. The firm can either choose to hone the firm's fit in the current market or to attempt an entrepreneurial fitting in a new market.

AN EXAMPLE OF THE FITTING DYNAMIC FROM AUSTRIAN ECONOMICS

Rent Seeking and the Fitting Dynamic

Consider the fitting dynamic and rent seeking process cycle entailed in a "new" competitive arena. Firm 1 using an entrepreneurial strategy enters into a virgin competitive arena and thus makes the first choice in attaining fit (See Figure 1). The entry into the market takes place at Time₀. Until the firm begins to make a profit, the "new" market is ignored by most possible competitors (Firms 2-4).

Once a firm begins to earn a profit (or have large sales which imply a profit), a signal is sent to possible competitors that a "new" market might have been "found." Since only one firm has achieved the profit for a short time, other firms with lower risk tolerances will be reluctant to move. A rapid second mover orientation and a slightly lower risk tolerance than the original firm is required for the next firm to enter the market (Firm 2). If that firm is also profitable, then a third firm (Firm 3) will enter the market and so on with the time between entries decreasing (shown by the decreasing distance between dotted lines in Figure 1) as firms become more confident of the reality of that market.

As can be seen in Figure 1, several firms can earn E-rents but the first firm to enter the market earns the most rents with subsequent entries both earning some rents but eroding the rents of others. This also shows how the market as defined by the firms creates a competitive parity situation which subsequent firms must meet (see Firm 6). The more attractive the market, the shorter the time between T₀, T₁, T₂, etc. If the information to determine either what the market is, or how to compete in the market does not then the time between T₀ and T₁, etc. may be lengthened.

The first firm to enter the market place earns E-rents. Once several firms enter the market, the E-rents will be dissipated due to competition. Other rents may still be earned either sequentially or simultaneously. These include Ricardian, Pareto, and Pareto-Marshall. It is these rents that all who subsequently enter the market compete for and away. There are a multitude of ways these rents

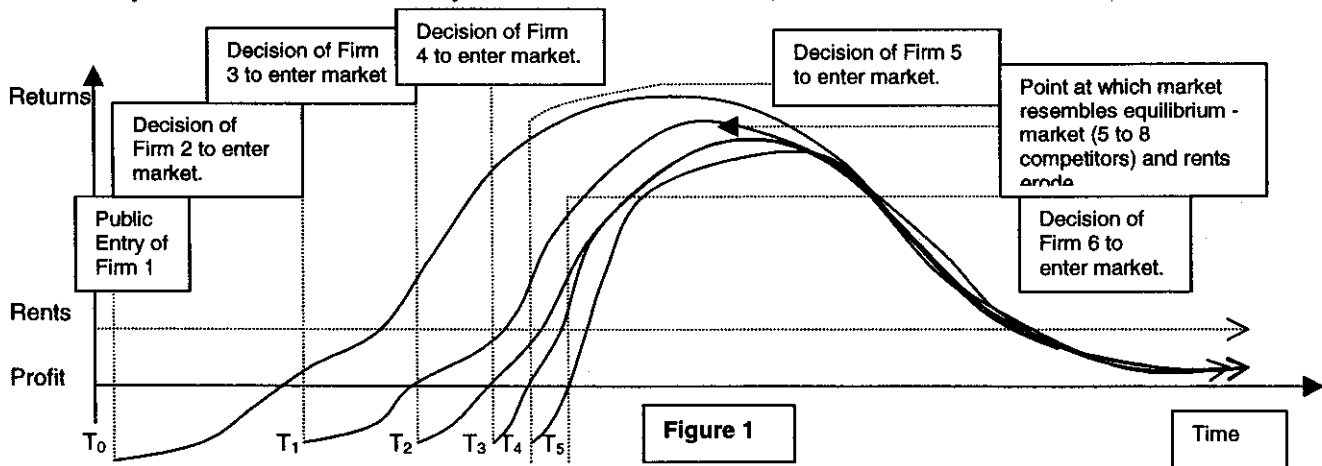
can be earned due to the only partially known nature of the fit that is generating the rents. The same process as found in the erosion of E-rents occurs here (See Figure 1). Each honing or converging innovation that fits can result in these rents. However, as each revealed fit becomes known, the rents erode to normal profits (when the spreading of information results in increased imitation and substitution). Resources that once conferred a competitive advantage now only provide a competitive parity.

When the rent return is eroding (as indicated by a decline in the growth rate of rents), the entrepreneurial firm looks to maintain the higher rate of return. They can achieve this via the fitting process of either seeking the rents arising from honing (convergence on a better fit in that market or arena) or seeking the rents arising from entrepreneurial innovations (divergence away from that market and towards a new market).

The first possibility is to hone a firm's fit in the current market, in other words, to pursue Pareto, Pareto-M and Ricardian rents. The firm initiates a series of innovation rounds. If this innovation "fits" as indicated by the earning of rents. As other firms notice and respond to the innovation, the rate of return will decline to the degree that the competing firms have also created fit. When this happens, Firm 1 can introduce Honing Innovation 2 and the fitting dynamic repeats. With each innovation, the firm hones its fit by converging on the unknown ideal fit (which changes with each innovation) and subsequently reveals more about that elusive fit. The entrepreneurial firm may continue to hone this fit as long as it is warranted. When the return rate drops below an acceptable level the firm may either change its definition of evidence of an acceptable fit, or look for another marketplace to enter.

The second avenue available to firms for maintaining or increasing rents is entry into a new marketplace. By moving to compete in a previously empty marketplace, the firm creates a fit for itself and reveals the new market. Any potential competitor who becomes aware of this new market now finds itself in misfit with the expanded environment. As other competitors enter the new market, the previously described fit honing process begins anew.

When a firm takes an early second mover orientation, both entrepreneurial and efficiency rents may be simultaneously earned. This occurs when the firm both successfully competes (whether via a different micro-niche in that market or via an equivalent fit) and also earns Ricardian, Pareto-Marshall or Pareto rents. Leapfrogging over the initial entrepreneurial firm can result in even larger total returns than those that the initial entrepreneurial firm earned.



The seeking of specific types of rent reflects different concepts of fitting. The efficiency rents reflect a convergent fitting using the honing process. The entrepreneurial rent seeking reflects a divergent fitting since the new fit is differentiated from the previously identified fit. Both result in competitors reevaluating their own degree of fit. The interaction of the two types of rent seeking (entrepreneurial versus efficiency), the competitive cycle (rent erosion) and the fitting processes (convergent and divergent) constitute the fitting dynamic.

The Fitting Dynamic And The Marketplace

The enacting of any organizations fitting choice in a marketplace causes the available information understood about that market as a whole to change. When noticed, this information stimulates competing organizations to reassess their degree of fit. The reassessment usually results in changes by the reassessing organizations; which, in turn, sparks reassessment by others. This type of a marketplace exhibits many features of a Boolean network system (Stacey, 1995). In such a system, any one element is connected to and both sends and receives signals to the others in the system. The current state of any element "changes from moment to moment according to the information or energy it receives and the rules it follows for converting these to action or outputs" (Stacey, 1995; 487). This implies that the organizations in a competitive arena help create the changing or turbulent environment (albeit not all change in the environment is due to changes by the organizations inhabiting it).

IMPLICATIONS FROM AUSTRIAN ECONOMICS AND THE FITTING DYNAMIC FOR ORGANIZATION STUDIES

Most organizational environments now are considered turbulent (Huber & Glick, 1993), so not only does an organization need to engage in fitting, it needs to also coordinate its rate of change with that of the environment. Two illustrations of organizational fitting decision points beyond that of rent attenuation follow. First, a discontinuous change within a product-market environment (e.g. the advent of personal computers) will require a reassessment and a fitting dynamic choice. Such discontinuous changes act as additional sources that need to be responded to and can potentially increase environmental turbulence.

Second, if an organization changes its current product-market environment leaving *Market A* for *market B*, it will simultaneously create better fit for the remaining current occupants of the *Market A* environment, remove a source of information about *Market A*, and decrease the turbulence in *Market A*. The better fit occurs when the returns are spread over a smaller number of firms. The removal of the firm's actions reduce available information about that market, decreases the total number of potential respondents and responses, decreasing the stimuli that must be responded to by those who remain, finally resulting in a less turbulent environment.

Furthermore, the above two examples suggest that better fit may not be in the direction of where the currently best performing organization *is located now* but in *anticipating* where they *will be in the future*. However, because the currently best performing organization reveals information about an environment, they reduce equivocality and will draw those who either cannot or choose not to reduce the equivocality and ambiguity inherent in the marketplace on their own. If successful, these secondary firms will also provide information about the market and help in the further spread of information about the market. They may not earn E-rents but may earn any of the other rents. This action again reinforces the idea that firms use and are satisfied with different definitions of fit. Once moves are made, the remaining firms in the competitive arena reevaluate their fits and make their own moves.

Thus the fitting dynamic impacts the entire competitive environment. The use of dynamic rents when considered in conjunction with a fitting process choice reveals resource use implications of the fitting dynamic (see Table 1). When the type of rent is known and the current use of a resource set is understood a firm is in a better position to purposefully address the future. This information is valuable for decisions regarding both short and long term issues and activities. As mentioned earlier, an organization's attempts at better fit, if successful will result in a need for competitors to reexamine their own fit with a possible evaluation of misfit occurring. The success of any one fitting event causes the others to mimic that performer (DiMaggio & Powell, 1983), potentially causing misfit for the best performer.

Table 1
The Fitting Dynamic & Rents

	Honing Fitting	Enterprising Fitting
Monopoly Rents	NA	NA
Entrepreneurial Rents	NA	Reveals current relatively better fit with new market. Erodes after more than 5-8 firms are in the market
Ricardian Rents	Reveals use of superior yet scarce resources that have a fit with a market that have not yet been copied nor substituted for.	Reveals use of superior yet scarce resources that have a fit with a market that have not yet been copied nor substituted for.
Pareto-Marshall Rents	Reveals a different use and hence a fit not anticipated by the factor market.	Reveals a different use and hence a fit not anticipated by the factor market.
Pareto Rents	Reveals a better use of resources within a firm as revealed by the excess of the resources over its next best use.	NA

Furthermore, the concept of the fitting dynamic then spotlights some key factors for a firm to consider: 1) arising from an understanding of the critical nature of information diffusion from Austrian Economics *information diffusion dynamics* including perceptual differences and tolerances to ambiguity and equivocality. 2) Also arising from the critical components of the driving of the marketplace from Austrian Economics, the effective creation and use of *innovation and entrepreneurial activities*. 3) Implied from the dynamics of the marketplace from this disequilibrium-basis is also *organizational learning* (using the ever changing set of market information and the seeking of Pareto, Pareto-Marshall and Ricardian rents). 4) From understanding the changes that occur in the environment from the active players, there is also an *implied need to understand how firms will adapt and change* in response to and to provoke change in others. 5) From the linkage between the disequilibrium and equilibrium orientations, there is an implied need to understand the *implications on potential strategy choices and the strategic uses of an explicit specification of rent orientation*. And 6) from all of the above, it is apparent that we must continue in our efforts to *understand of the complexity of the marketplace and future issues arising from such complexity*.

Just as an understanding of firm activity rooted in the equilibrium economic systems sparked streams of

research to determine how effective that understanding was for both descriptive and predictive uses, this disequilibrium-based theoretical understanding should spark and or reinvigorate streams examining this set of identified critical issues.

CONCLUSION

Because of the complex nature of the market when defined in this manner (Stacey, 1995), attainment of fit is elusive. Fit no longer is defined as an attainable "end state" but rather as a relative state that is a process and is explicitly dynamic. The fitting dynamic helps explain action in complex markets such as those based on disequilibrium theories. Understanding the movement of firms in the market is possible by considering the two fitting dynamics of convergence and divergence and the resulting rent seeking activities. For example, consider the movements explained by examining the set of actions and reactions via the fitting dynamics involved of an entrepreneurial firm's fitting choices. If it chooses to converge on a current competitive arena fit, it may generate rents via the creation of the better fit while simultaneously causing the reevaluation by competitors of their own fits. The entrepreneurial firm may also choose to leave a current market for a new market. Whether or not it creates a better fit for itself, by just revealing the market, it creates the misfit of others for that new market.

It is clear that as revealed by Table 1, the fitting dynamic both illuminates and is illuminated by rent seeking. This view of fit as the explicit fitting dynamic helps us to begin to explain organizational activity in a richer way than fit has previously been presented. It confirms and highlights the importance of several strategic issues and provides a way to more closely analyze and determine a firm's strategic orientation. The fitting dynamic perspective builds on the previous definitions of fit while demonstrating the usefulness of studying the dynamics of the attainment of fit. An important aspect of this dynamic is the explanation of how firms who seek rents provide the driving force of the economy.

Further areas of importance for new or renewed research include: 1) entrepreneurship and innovation; 2) information processing dynamics including both technological incorporation and intra-personal perceptual issues; 3) management of strategies in conditions of environmental dynamism and complexity; and 4) organizational learning and change in response to environmental change and as proactive influences in environmental change. What an exciting time to be studying organizations! We have accomplished much in understanding rather predictable and stable environments and now can turn our attention to more complex environments and what it takes to survive and thrive in such conditions.

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