



INDEPENDENT JOURNAL OF MANAGEMENT & PRODUCTION (IJM&P)  
http://www.ijmp.jor.br  
ISSN: 2236-269X  
DOI: 10.14807/ijmp.v4i1.63

v. 4, n. 1, January – June 2013.

## PRINCIPLES & DIMENSIONS OF MARKET-BASED MANAGEMENT ® (MBM)

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*Submission: 16/03/2013*

*Accept: 21/03/2013*

### **ABSTRACT**

The foundations, principles and dimensions of Market-Based Management® (MBM), a management system that allows organizations to be successful by applying the principles that enable free societies to become prosperous, is analyzed and reviewed. Pioneered and trademarked by Charles G. Koch, Chairman of the Board and CEO of Koch Industries, MBM seeks to adapt the principles of a free society and market economy to improve management practice in organizations.

**Keywords:** market-based management; Koch Industries; management system



## **1. INTRODUCTION**

The purpose of this essay is to analyze and discuss the foundations, principles and dimensions of Market-Based Management® (MBM), a management system that allows organizations to be successful by applying the principles that enable free societies to become prosperous (CHARLES KOCH INSTITUTE, 2013). Pioneered and trademarked by Charles G. Koch, Chairman of the Board and CEO of Koch Industries, MBM “seeks to adapt the principles of a free society and market economy to improve management practice in organizations” (ELLIG, 1996, p. 73). Holian (2007) added that MBM “attempts to harness the power of markets inside a firm” (p. 23). Moreover, Evans (2013) argued that MBM allows workers more access to the decision-making process in large firms. Finally, Gable (1995) concluded that MBM fosters a decentralized decision-making process despite the job title. In addition to a review of the literature, case studies of corporations utilizing MBM will be discussed as well as applications of MBM outside of the private sector. Let us review some of the economic theories that are the foundations of MBM.

## **2. FOUNDATIONS OF MBM**

In order to develop MBM, Koch (2007) relied heavily on the Austrian school of economics, particularly the theories of Hayek, Mises and Schumpeter. Hayek (1979) emphasized that there are differences between orders and organizations where orders occur when “individuals mutually adjust their behavior to each other based on some general rules” while organizations are created when “someone consciously plans how the individuals will relate to each other” (ELLIG, 1995, p. 33). Spontaneous or extended orders are superior to any order that can be achieved by the human mind due to the specifics of the information or data required (HAYEK, 1991). In essence, the members of the economic system use their knowledge and energy to create value (GABLE, 1995).

Coase (1937) defined the role of the firm in economic systems where the firm is a consciously planned organization while the market is more of a spontaneous order (ELLIG, 1995). Moreover, firms have an explained

existence, boundaries and internal organizations that are identified via the employment contract and the notion of authority (FOSS, 2002).

Jensen & Meckling (1992) argued that a firm's decision-making authority should be moved to where the knowledge is located as opposed to vice versa (ELLIG, 1995). In Central and Eastern Europe and the former Soviet Union, centrally planned enterprises failed and are now benefiting from the efficiencies associated with the free market (COWEN & PARKER, 1997). Even China's state-owned enterprises, such as their Big Four banks, are now being publicly traded on stock exchanges and are expanding outside of China into foreign markets including Africa, the Americas and Europe. These definitions and notions, amongst others, provided the foundation for Market-Based Management® (MBM). Let us review the elements of market economies and organizations.

### **2.1. Elements of market economies and organizations**

Based upon the economic theories of the Austrian school, such as property rights and free markets, MBM "seeks to improve organizational performance by exploring analogous elements in market economies and organizations" (ELLIG, 1996, p. 740). MBM focuses on six key elements of the market economy: 1. Specialization through comparative advantage 2. Rules of just conduct 3. Property rights 4. Market incentive 5. Free flow of ideas 6. Price system (ELLIG, 1995, p. 36).

Adam Smith argued in his *Wealth of Nations* that an advanced division of labor was fundamental for economic prosperity. An extended definition of this theory is often referred to as *comparative advantage*, which shows how an individual can create wealth by specializing in activities that will create the most value with the least amount of resources (ELLIG & GABLE, 1995, p. 436).

Based on Hayek's rules of conduct, the market economy system referred to as *rules of just conduct* includes a firm's values and its culture. Values such as respect for personal dignity and property, intellectual honesty, humility, an open mind and the freedom to question the status quo are ones that lead to prosperity (ELLIG & GABLE, 1995, p. 436). Koch Industries has a

statement of corporate principles that includes: humility, intellectual honesty, openness, receptiveness to new ideas, treating others with dignity and respect, recognizing and using everyone's unique knowledge and abilities, and instilling a commitment to the common mission (ELLIG & GABLE, 1993).

According to Mises, *property rights* are akin to the rights of decision-making within a firm (BOETTKE, COYNE & LEESON, 2008). In a market economy, property rights are controlled by those who create value and can be lost when they do not.

*Market incentive* includes motivation as “entrepreneurs earn profits by thinking up new ways to create value for others” (ELLIG & GABLE, 1995, p. 437). Nucor Corporation incentivizes their employees’ production output on a weekly basis (ELLIG, 1995, p. 39).

*Free flow of ideas* and the use of knowledge include both freedom of action, exchange and speech. By allowing employees to make decisions based on local knowledge, productivity is increased within the firm and the focus is more “client centric” (ELLIG, 1995, pp. 39 – 40).

*Price system* and internal markets relate to Hayek (1945) and his view of the price system in a market economy (ELLIG, 1995, p. 40). The practice of having internal customers pay for a firm’s overhead is widely popular with firms such as Bell Atlantic, Weyerhaeuser and Koch Industries (ELLIG & GABLE, 1995, p. 437). Many firms today outsource services such as accounting and information technology in order to control costs and increase profitability.

Moreover, there are six parallel elements within organizations: 1. Mission system 2. Values and culture 3. Roles and responsibilities 4. Compensation and motivation 5. Generation and use of knowledge 6. Internal markets (ELLIG, 1995, p. 36). Now let us review the guiding principles of MBM.

## **2.2. Guiding Principles**

According to the Charles Koch Institute:

Market-Based Management® requires a culture centered on specific characteristics. These attributes set the standards for evaluating policies, practices and conduct, establishing norms of behavior, and building the shared values that guide individual actions. The guiding principles articulate rules of just conduct along with values and beliefs. (CHARLES KOCH INSTITUTE, 2013)

There are ten guiding principles of MBM:

1. Integrity - Conduct all affairs with integrity, for which courage is the foundation. Honor donor intent.
2. Compliance - Strive for 10,000% compliance with all laws and regulations, which requires 100% of employees fully complying 100% of the time. Stop, think, and ask.
3. Value creation - Contribute to societal well-being by advancing the ideas, values, policies, and practices of free societies. Understand, develop, and apply MBM to achieve superior results by making better decisions, eliminating waste, optimizing, and innovating.
4. Principled entrepreneurship™ - Apply the judgment, responsibility, initiative, economic and critical thinking skills, and sense of urgency necessary to generate the greatest contribution, consistent with the organization's risk philosophy.
5. Customer focus - Discover, collaborate, and partner with those who can most effectively advance free societies.
6. Knowledge - Seek and use the best knowledge and proactively share your knowledge while embracing a challenge process. Develop measures that lead to more effective action.
7. Change - Anticipate and embrace change. Envision what could be, challenge the status quo, and drive creative destruction through experimental discovery.
8. Humility - Exemplify humility and intellectual honesty. Constantly seek to understand and constructively deal with reality to create value and achieve personal improvement. Hold yourself and others accountable.

9. Respect - Treat others with honesty, dignity, respect, and sensitivity. Appreciate the value of diversity, including, but not limited to, diversity in experiences, perspectives, knowledge, and ideas. Encourage and practice teamwork.
10. Fulfillment - Find fulfillment and meaning in your work by fully developing your capabilities to produce results that create the greatest value (CHARLES KOCH INSTITUTE, 2013).

The guiding principles of MBM are clearly linked to the tenets of the Austrian school of economics. The principles of integrity and respect tie into Hayek's "rules of conduct" notion and the principle of knowledge can be paralleled to Hayek's 1937 and 1945 essays on knowledge. Under the broad notion of competition, the principles of entrepreneurship, value creation and customer focus follow the economic theories of Schumpeter, Hayek and Kirzner (ELLIG, 1996, p. 83). Let us review the five dimensions of MBM.

### **2.3. The Five Dimensions**

According to the Charles Koch Institute, there are five dimensions to MBM:

1. Vision - Determining where and how the organization can create the greatest long-term value.
2. Virtue and Talents - Helping ensure that people with the right values, skills, and capabilities are hired, retained, and developed.
3. Knowledge Processes - Creating, acquiring, sharing, and applying relevant knowledge, and measuring and tracking profitability.
4. Decision Rights - Ensuring the right people are in the right roles with the right authority to make decisions and holding them accountable.
5. Incentives - Rewarding people according to the value they create for the organization. (CHARLES KOCH INSTITUTE, 2013)

### **3. CASE STUDIES AND APPLICATIONS**

Clark Equipment utilizes the organizational system of internal markets by breaking its corporate staff and departments such as accounting, data

processing, legal and trucking into profit centers, which eliminated bureaucracy within the firm (GABLE, 1995).

Koch Industries is a privately-owned holding company that includes businesses such as Georgia-Pacific, Invista and Dixie Brand Products. Accounting, information systems, legal, and other staff services are bought and sold through an internal market system (GABLE, 1995). Rather than being vertically integrated, as many energy companies are, Koch Industries focuses on industry segments such as “gathering, transportation, refining and trading” and does the same with related industries in order to exploit comparative advantages (ELLIG, 1995, p. 37).

Nucor Corporation is a steel company based in Charlotte, North Carolina that, on a weekly basis, rewards its production employees with bonus pay, solely based on team productivity (GABLE, 1995). The management of the firm understands that employees will make mistakes and encourage values that promote prosperity (ELLIG, 1995).

Semco, a Brazilian manufacturer, utilizes alternative management practices such as no dress codes, expense reimbursement policies and does not set work hours or have time clocks (ELLIG, 1995, p. 38). This is an example of the market economy system known as the “rules of just contact” (ELLIG & GABLE, 1995, p. 436).

Tamko Roofing Products of Joplin, Missouri uses the concept of property rights via decision-making as they have replaced budgets with “spending authorities that allow them to exercise wide discretion about corporate purchases” (ELLIG, 1995, p. 36).

Market-Based Management (MBM) is applicable to not only corporations, but can be applied to the public sector as well. Education systems can benefit from MBM as schools depend on knowledge as their primary method of creating value (STANFIELD, 2007). Another possible use of MBM is in the management of American and British police forces as they embrace the use of statistics, empowering police sergeants and their precincts (HOLIAN, 2007).

#### **4. CONCLUSION**



Conversely, there are scholars that have some concerns about MBM “because they perceive all the market based talk as a form of ‘economic imperialism’ that seeks to reduce all human behavior to hyper-rational self-interested optimizing’ (ELLIG, 1996, p. 73). “Markets and organizations differ in a fundamental way, and there is no guarantee that one can transplant techniques that are successful in organizations to markets or vice versa” (HOLIAN, 2007, p. 28).

In addition, there are management theories that are related to MBM including Total Quality Management (TQM) and Stern & Stewart’s Economic Value Added (EVA). MBM is broader than Total Quality Management (TQM), because TQM deals only with the values/cultures, roles/responsibilities and knowledge systems of a firm (PYZDEK, 1996). MBM is a scientific approach to management that integrates theory and practice, and provides a framework for dealing with the ongoing challenges of growth and change (KOCH, 2007). The Austrian concept of opportunity cost of capital is related to EVA as is providing ownership opportunities to employees (SKOUSEN, 2008).

MBM abandons Keynesian economics and the centrally planned organizations of Communism and embraces the knowledge-based enterprises of the free market economy. When people are empowered and are treated with dignity and respect, they are able to generate more value for both themselves and their firm as they feel as though they are part of the new breed of knowledge entrepreneurs.

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