

Acceptance remarks by **Charles G. Koch**, 2005 Herman W. Lay Memorial Award recipient of The Association of Private Enterprise Education on April 3, 2005 in Orlando, Florida.

Koch Industries, Market Process Analysis, and the Science of Liberty

Charles G. Koch*

Thank you, Wendy [*Gramm, Distinguished Senior Scholar, Mercatus Center, George Mason University*] for that generous introduction. I am greatly honored to receive this award from an organization that shares my commitment to prosperity through freedom.

And that is the subject of my remarks: How to bring about the free society by applying Market Process Analysis and the Science of Liberty.

I'll start with a little history of how I got involved with these ideas. After graduating from MIT, I went to work for Arthur D. Little, then a leading consulting firm.

After I had been at ADL for about two years, my father began pressuring me to join his firm. But I was learning a lot and enjoyed what I was doing, so I turned him down. Finally, he made me an offer I

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couldn't refuse. He said his health was poor, and either I come back to run the company or he would sell it.

I joined the company in 1961 and was blessed to work with him for six years until his death in 1967. It was from him that I absorbed the foundational values of a free society—integrity, humility, learning, and hard work.

His first words to me when I joined the company illustrated his regard for humility: "I hope your first deal is a loser. Otherwise, you'll think you're a lot smarter than you are." He had nothing to worry about. I got us in plenty of losers.

After joining the company, I developed two great passions. One was to help build a successful company. The other was to understand the principles that lead to prosperity and social progress. What initially inspired me was Baldy Harper's little book, *Why Wages Rise*. It convinced me that it was possible to understand and help improve the social world, just as it was the physical world. As a result, I had what Abraham Maslow called a "peak experience," and I've never looked back.

As is true for many of you, my studies led me to believe that a free society is the form of social organization that best fosters prosperity and social progress. By 1964, I was looking for ways to develop, apply, and spread the ideas I was learning. Since then, I have helped found or support many, many organizations that I felt were contributing to liberty and the general welfare.

While I was helping build these organizations, we were also building Koch Industries. I didn't realize at the time how valuable my studies would be in that regard—that the same principles that enable a market economy to prosper could also work when applied in a company or by individuals. Over the years, we learned, through trial and error, and many missteps, how to apply these principles to our businesses in a way that gets results.

What we came to understand is that we were dealing with various applications of a single, overall framework: Market Process Analysis—the study of how people interact in society to best use scarce

resources to satisfy their ends while contributing to the general welfare. As such, it is the study of the process by which laws, customs, culture, incentives, and learning lead to a spontaneous order that results in the greatest social progress.

We have found the application of MPA to be extremely powerful in creating prosperity not only for society as a whole, but for individuals and organizations as well. Understanding MPA has enabled me to have a holistic approach to life—in my personal development, in my family life, in dealing with others, in running our company, in charitable work, and in our social change efforts. Applying the principles of MPA can be very powerful in helping an individual fully develop his abilities, in making a business successful, and in establishing a prosperous and civil society.

Although we don't have enough time to discuss individual development, I will spend a few minutes on the application of MPA within an organization, which I call Market Based Management®. I attribute KII's success to MBM®. I will also share a few observations that have implications for the application of MPA to society—what we call the Science of Liberty.

In MBM, one of the concepts we have used to great benefit is Schumpeter's theory of creative destruction. Creative destruction and the other concepts taken from MPA guide everything we do. For example, my father developed several fractionation devices, which separate liquids by boiling point. One, the Kaskade tray, he abandoned when a customer accidentally installed it upside down and found it worked better.

Very few companies have been able to match the creative destruction of the marketplace. Only 2 percent of the companies on the original S&P 500 list have grown more than the market as a whole. Since 1960, the stock market has grown roughly 100-fold, assuming reinvestment of dividends. Using the same assumptions, we have grown more than 1,400-fold, or 14 times the growth of the market. How? By developing and applying MBM.

We have found that MBM can work anywhere, even at our ranches. It transformed our Montana ranch, increasing revenue by 35 percent while reducing costs by 25 percent and greatly improving the ranch environmentally. This was the first ranch in the country to be certified by the Wildlife Habitat Council.

We have learned the hard way that there are two parts to using MBM to drive creative destruction and value creation: one is learning the concepts, but much more difficult is learning how to apply them successfully. What has made MBM particularly challenging is the tendency to try to duplicate the form or mechanisms of the market economy in the firm. This can be disastrous.

With a few exceptions, organizations advocating the free society have failed to apply market concepts internally. During my 40 years in this effort, I've constantly been taken aback by market advocates' lack of recognition that maintaining the status quo results in the loss of effectiveness. I'll never forget the leader of one prominent pro-market non-profit telling me that he agreed about the need for change for others but that his approach had been perfected. I'll let you guess my reaction. The need for creative destruction is not just a business phenomenon; it also applies to economics and the other sciences.

Three sets of experiences over the last 40 years have led me to understand the need for MPA and, more broadly, the Science of Liberty, to advance the free society:

1. The lack of success of free-market economists in addressing problems in mixed economies.
2. Our lack of success in constraining growth in government.
3. Our success in applying MBM in KII.

The Science of Liberty—the study and practice of sustainably advancing liberty to create prosperity and social progress—involves much more than studying why free societies are wealthy and un-free societies are poor. It involves understanding and creating social change.

We are particularly weak in understanding, implementing, and sustaining transitions to a free society. Thus, we need to learn to answer questions such as:

- Why do free societies adapt policies that erode their freedom and prosperity?
- Why do producers in free societies create fertile ground for and actually fund predators dedicated to their destruction?
- What are the critical steps in the successes and failures in attempts to move from un-free to free?
- What changes in rules and property rights would cause public companies to focus on creating real long-term value rather than on wastefully and, sometimes corruptly, meeting quarterly earnings projections?

Liberty, properly conceived, has the high moral ground, but, for that to be credible, business people and academics must demonstrate a much higher level of integrity and humility.

There are dozens of other key questions yet to be adequately addressed. Due to the incentive structure in the academic arena, much academic research is very clever, but trivial. Because of what is at stake—freedom and prosperity in the world—we need talented, brave, open-minded, pro-market thinkers to tackle critical Science of Liberty research topics.

Based on our 40 years of social change work and our experience in the development and application of MBM, I believe that our efforts to advance the Science of Liberty need to be:

- Interdisciplinary;
- Fully integrated with practice and practitioners;
- Focused on understanding and implementing productive transitional policies in mixed economies; and

- Subjected to rigorous challenge and experimentation before policies and practices are recommended and implemented.

The Mercatus Center and the Institute for Humane Studies at George Mason University focus on coordinating, facilitating, and supporting the Science of Liberty. Tony Woodlief (Mercatus Center President) and Wendy Gramm are great contacts for all of you who are interested in helping advance liberty and prosperity through the Science of Liberty.

Thank you.