Chapter 7: Entrepreneurship and the Theory of the Firm

I. Innovation—An Important Missing Cause of Economic Development

Neoclassical economics assumes that a convenient starting point for price theory is the existence of firms and consumers that are predisposed to engage in voluntary exchange. Firms attract and retain their labor forces and ongoing contractual relationships with other input providers and are well aware of other potential input providers that could be used. Consumers, likewise, have continuing relationships with firms from whom they buy or potentially may purchase their goods and services from. It is such continuing relationships that make the informational assumptions plausible. In such cases, firms will know input prices and consumers the prices of outputs. Market relationships are continuing and, in a sense, long term ones under which consumers and firms repeat their pattern of production and purchase every year. Minor refinements in tastes and production methods may occur, but the economy is in what has been termed and evenly rotating economy. Wages and rental payments to input providers provide the income necessary to demand exactly what is produced in all the markets frequented by consumers. Essentially the same products are produce in the same manner every year. The effects of any stochastic phenomena are well known, and addressed through various insurance-like products.

There are a number of assumptions in that approach some of which were consciously made when neoclassical economics first emerged as a coherent method of understanding, in the main, how complex networks of exchange and production operate. One is that such networks exist—no effort is made to understand how they might have emerged. Another is that the product mix produced is stable through time—for many years if not decades or centuries. No radically new products are brought to market, no radical new productions invented, and no unanticipated events occur. Even if a bit of ignorance about possible outcomes is acknowledged, it is assumed that what need to be known is already known and incorporated into market prices and price-induced patterns of production and consumption.

Oddly enough, such assumptions were plausible when classical economic emerged in the eighteenth century and arguably through the first half of the nineteenth century. The core of the European product mix had not changed for centuries. And, although there were break throughs in production technologies, outside the buildings in which such activities took place, relatively little would be known about them, because essentially similar products were being produced. Clothing when through cycles of fashion, but that the cloth was increasingly automated and propelled by wind and water made little difference to consumers except insofar as the cost of clothing fell, freeing their income for other purposes. Such changes often proceeded slowly as rival firms figured out how the occasional innovator managed to produce rival products more quickly or cheaply.

This changed in the second half of the nineteenth century, as various entirely new products and services were brought to market. The railroad was more than a better horse and buggy. The lightbulb was more than a fancy candle. The steam ship was more than a new type of sailboat. The automobile and airplane were new modes of transportation not simply enhancement of the old ways, which had relied on animal muscle power for millennia. New and improved production methods were adopted that required far larger investments and markets to take advantage of. Although there had been rich people for thousands of years, they were mostly persons that owned or controlled large pieces of land. In the nineteenth century, persons that created new organizations to produce new services in new ways became increasingly common as rich folks—they were initially looked down by the old wealthy landowner class, and chided for being "capitalists"—the owners and builders of large firms with large capital assets.

Innovation became routine, in part, because innovation turned out to be a very profitable activity. There were many areas of life in which unrealized gains form production and exchange could be realized. And fortunes were amassed by doing so.

Although this period of innovation-driven commerce was well underway by the time that neoclassical economics emerged, it did not find its way into neoclassical models. Innovations, once they have been established, could easily be brought into the standard models, but not the process of innovations which brought entirely new products to market or new production methods into use. Such events implied that gaps in knowledge occurred—not simply probabilistic types of uncertainty, but what Frank Knight termed unmeasurable uncertainty. Not only the probabilities were unknown and perhaps unknowable, but the domain of possibilities were as well. A different kind of imperfect information and several types of activities had to be taken into account than neoclassical theories of equilibrium prices could easily incorporate. These were not factors that could be ignored in the twentieth century (although they were), because so much of economic growth involved the introduction of entirely new products and services, often produced in entirely new ways—ways that a few decades earlier would have been widely regarded as impossible!

II. Theories of Entrepreneurship

Of course, innovation begets innovation and as the profits of entrepreneurship came to be recognized, economists naturally attempted to explain where they came from. Knight's classic book surveys the field as existed in the early twentieth century and from that survey, it seems clear that many of the key ideas had been at least touched on if not carefully worked out by the time he wrote his dissertation on risk, uncertainty, and profit. In the years after Knight's famous book, there came to be four strands in the theory of entrepreneurship and innovation.

First, Knight's (xxxx) theory which suggests that entrepreneurial profits arise from a willingness to bear risk of a sort where neither the probability of outcomes nor all the outcomes could be determined beforehand. Entrepreneurs were risk takes for risks that could not be insured.

Second. Shumpeter's (xxxx, xxxx) theory suggests that entrepreneurial profits arise from innovation itself—by successfully bringing new products or new methods of production to markets. Third, Kirzner (xxxx, xxxx) argued that entrepreneurial profits were realized by persons who, somehow were able to "see" unrealized gains to trade that might be realized though what might be termed "price disequilibrium," which would include pure speculative profits realized by purchasing "under priced" resources and selling them as those price rose to their appropriate equilibrium prices. It would also include innovations of the Schumpeter variety insofar as product innovation can be interpreted as cases where collections of inputs could be used in new ways to produce goods that had a higher price than other uses of those resources generated.

Fourth, there is the model of entrepreneurship as organization builders (who I refer to as formeteurs). Such entrepreneurs are residual claimants on any and all productivity gains that their new organizations are able to realize, which would include profits of the Knight, Schumpeter, and Kirzner variety. Although the idea goes back to the late nineteenth century, contemporary credit is often given to Alchian and Demsetz (1972).

References

Alchian, A. A., & Demsetz, H. (1972). Production, information costs, and economic organization. *The American Economic Review*, *62*(5), 777-795.

Brouwer, M. T. (2002). Weber, Schumpeter and Knight on entrepreneurship and economic development. *Journal of Evolutionary Economics*, *12*, 83-105.

Kirzner, I. M. (2015). *Competition and Entrepreneurship*. Chicago, IL: University of Chicago Press.

Knight, F. H. (1921). *Risk, Uncertainty and Profit*. Boston MA: Houghton Mifflin.

Schumpeter, J. A. (1939). *Business cycles* (Vol. 1, pp. 161-174). New York: Mcgraw-Hill.

Schumpeter, J. A. (2013). *Capitalism, Socialism and Democracy*. London: Routledge.