

AMBO UNIVERSITY, WOLISO CAMPUS

SCHOOL OF GOVERNANCE AND LAW

**DEPARTMENT OF GOVERNANCE AND
DEVELOPMENT STUDIES**

**TEACHING MATERIAL FOR THE COURSE:
ENTREPRENEURSHIP AND DEVELOPMENT (GaDS3104)**

For 3rd year Students

MAY, 2020

Chapter -1 Introduction to Entrepreneurship in Economic Development

1. The Concept of the Entrepreneurship

1.1. Meaning and Feature of Entrepreneurship

There has been a great deal of attention paid to the subject of entrepreneurship over the past few years, stemming primarily from the discovery by economic analysts that small firms contribute considerably to economic growth and vitality. Moreover, many people have chosen entrepreneurial careers because doing so seems to offer greater economic and psychological rewards than does the large company route. Leaders should strive to identify potential entrepreneurs from within the target group of unemployed graduates and, to a certain extent, teach entrepreneurship.

Many definitions of entrepreneurship can be found in the literature describing business processes. The earliest definition of entrepreneurship, dating from the eighteenth century, used it as an economic term describing the process of bearing the risk of buying at certain prices and selling at uncertain prices. Other, analysts broadened the definition to include the concept of bringing together the factors of production. This definition led others to question whether there was any unique entrepreneurial function or whether it was simply a form of management.

Early this century, the concept of innovation was added to the definition of entrepreneurship. This innovation could be process innovation, market innovation, product innovation, factor innovation, and even organizational innovation. Later definitions described entrepreneurship as involving the creation of new enterprises and that the entrepreneur is the founder.

Considerable effort has also gone into trying to understand the psychological and sociological wellsprings of entrepreneurship. Those efforts have noted some common characteristics among entrepreneurs with respect to need for achievement, perceived locus of control, orientation toward intuitive rather than sensate thinking, and risk-taking propensity.

Many have commented upon the common, but not universal, thread of childhood deprivation, minority group membership and early adolescent economic experiences as typifying the entrepreneur.

At first glance then, we may have the beginnings of a definition of entrepreneurship. Consider, for example, the degree to which entrepreneurship is synonymous with 'bearing risk',

'innovation', or even founding a company. Each of the terms described above focuses upon some aspect of some entrepreneurs, but if one has to be the founder to be an entrepreneur, then neither Thomas Watson of IBM nor Ray Kroc of McDonald's will qualify; yet few would seriously argue that these individuals were not entrepreneurs.

Although risk bearing is an important element of entrepreneurial behavior, many entrepreneurs have succeeded by avoiding risk where possible and seeking others to bear the risk. One extremely successful entrepreneur has said; 'My idea of risk and reward is for me to get the reward and others to take the risks'.

There are similarly many questions about what the psychological and social traits of entrepreneurs are. The same traits shared by two individuals can often lead to vast different results: successful and unsuccessful entrepreneurs can share the characteristics commonly identified. As well, the studies of the life paths of entrepreneurs often show decreasing 'entrepreneurship' following success, which tends to disprove the centrality of character or personality traits as a sufficient basis for defining entrepreneurship.

Creativity is often not a prerequisite for entrepreneurship. Many successful entrepreneurs have been good at copying others and they qualify as innovators and creators only by stretching the definition beyond elastic limits.

1.1.1 Meaning of Entrepreneur and Entrepreneurship

The word "entrepreneur" originates from a thirteenth-century French verb, *entreprendre*, meaning "to do something" or "to undertake." By the sixteenth century, the noun form, *entrepreneur*, was being used to refer to someone who undertakes a business venture. It refers to those who "undertake" the risk of new enterprises". An enterprise is created by an entrepreneur. The process of creation is called "entrepreneurship

An entrepreneur is someone who organizes, manages, and assumes the risks of a business or enterprise. Most people think being an entrepreneur is all about coming up with an idea, but that's just one part. It's also important to know right from the start how you will reach interested customers in an effective and affordable way. It takes a special kind of person to become a successful entrepreneur. An entrepreneur is an agent of change.

An entrepreneur is someone who can take any idea, whether it be a product and/or service, and have the skill set, will and courage to take extreme risk to do whatever it takes to turn that concept into reality and not only bring it to market, but make it a viable product and/or service that people want or need.

Entrepreneurship is the development of a business from the ground up coming with an idea and turning it into a profitable business. But while the definition of entrepreneurship may be simple, its execution is much more difficult. Entrepreneurship is the journey of opportunity exploration and risk management to create value for profit and/or social good. Entrepreneurship entails recognizing the right opportunity, finding resources such as funding and tools to pursue the opportunity and creating the right team to do so. People who are thinking about starting their own business must really be aware that successful entrepreneurship involves much more than having a great concept.

Entrepreneurship is the process of discovering new ways of combining resources. When the market value generated by this new combination of resources is greater than the market value these resources can generate elsewhere individually or in some other combination, the entrepreneur makes a profit. For example, an entrepreneur who takes the resources necessary to produce a pair of jeans that can be sold for thirty dollars and instead turns them into a denim backpack that sells for fifty dollars will earn a profit by increasing the value those resources create.

This comparison is possible because in competitive resource markets, an entrepreneur's costs of production are determined by the prices required to bid the necessary resources away from alternative uses. Those prices will be equal to the value that the resources could create in their next-best alternate uses. Because the price of purchasing resources measures this opportunity cost, the value of the forgone alternatives—the profit entrepreneurs make reflects the amount by which they have increased the value generated by the resources under their control.

Entrepreneurs who make a loss, however, have reduced the value created by the resources under their control; that is, those resources could have produced more value elsewhere. Losses mean that an entrepreneur has essentially turned a fifty-dollar denim backpack into a thirty-dollar pair of jeans. This error in judgment is part of the entrepreneurial learning, or discovery, process vital to the efficient operation of markets. The profit-and-loss system of capitalism helps to quickly

sort through the many new resource combinations entrepreneurs discover. A vibrant, growing economy depends on the efficiency of the process by which new ideas are quickly discovered, acted on, and labeled as successes or failures.

Just as important as identifying successes is making sure that failures are quickly extinguished, freeing poorly used resources to go elsewhere. This is the positive side of business failure.

Successful entrepreneurs expand the size of the economic pie for everyone. Bill Gates, who as an undergraduate at Harvard developed BASIC for the first microcomputer, went on to help found Microsoft in 1975. During the 1980s, IBM contracted with Gates to provide the operating system for its computers, a system now known as MS-DOS. Gates procured the software from another firm, essentially turning the thirty-dollar pair of jeans into a multibillion-dollar product. Microsoft's Office and Windows operating software now run on about 90 percent of the world's computers. By making software that increases human productivity, Gates expanded our ability to generate output (and income), resulting in a higher standard of living for all.

Sam Walton, the founder of Wal-Mart, was another entrepreneur who touched millions of lives in a positive way. His innovations in distribution warehouse centers and inventory control allowed Wal-Mart to grow, in less than thirty years, from a single store in Arkansas to the nation's largest retail chain. Shoppers benefit from the low prices and convenient locations that Walton's Wal-Marts provide. Along with other entrepreneurs such as Ted Turner (CNN), Henry Ford (Ford Automobiles), Ray Kroc (McDonald's Franchising), and Fred Smith (FedEx), Walton significantly improved the everyday life of billions of people all over the world.

1.1.2 Shared Features of Entrepreneurship

Entrepreneurship is characterized by the following features:

- ***Economic and dynamic activity:*** Entrepreneurship is an economic activity because it involves the creation and operation of an enterprise with a view to creating value or wealth by ensuring optimum utilization of scarce resources. Since this value creation activity is performed continuously in the midst of uncertain business environment, therefore, entrepreneurship is regarded as a dynamic force.

- ***Related to innovation:*** Entrepreneurship involves a continuous search for new ideas. Entrepreneurship compels an individual to continuously evaluate the existing modes of business operations so that more efficient and effective systems can be evolved and adopted. In other words, entrepreneurship is a continuous effort for synergy (optimization of performance) in organizations.
- ***Profit potential:*** Profit potential is the likely level of return or compensation to the entrepreneur for taking on the risk of developing an idea into an actual business venture. Without profit potential, the efforts of entrepreneurs would remain only an abstract and a theoretical leisure activity.
- ***Risk bearing:*** The essence of entrepreneurship is the 'willingness to assume risk' arising out of the creation and implementation of new ideas. New ideas are always tentative and their results may not be instantaneous and positive. An entrepreneur has to have patience to see his efforts bear fruit. In the intervening period (time gap between the conception and implementation of an idea and its results), an entrepreneur has to assume risk. If an entrepreneur does not have the willingness to assume risk, entrepreneurship would never succeed.

1.2 Distinctions between the entrepreneur and other economic decision-makers

It is important to distil the most salient features that specifically distinguish the entrepreneurial function from other functions and that are also relevant for institutional analysis and public policy.

Each economic agent acts in an integrated manner, which we (as economists) artificially analyse as separate functions. The real-world entrepreneur is a single composite personality who is also a manager, leader, capitalist, coordinator and organiser. Thus, although entrepreneurial, managerial and capitalist functions are conceptually distinguishable, in the real world the activities are invariably intertwined. Owing to transaction costs and other factors, entrepreneurs must perform many non-entrepreneurial and managerial functions, and they must often provide some capital to facilitate the realisation of their own ideas. Transaction-cost factors inhibit the transfer of entrepreneurial knowledge and block the formation of an external market in which entrepreneurs could sell their ideas to other participants who could realise them.

I. Entrepreneurship versus resource ownership

Prior ownership of resources is not a prerequisite to entrepreneurial alertness (Kirzner 1979: 97). However, in a world in which production is not instantaneous and investment in capital is often required, we may observe entrepreneurs as owning resources as well. For the purpose of reallocating resources in the pursuit of profit, entrepreneurs may need to acquire them. For example, in order to exploit a perceived profit opportunity, it may be necessary to purchase an asset in period $t - 0$ to be sold for a higher price in the later period $t - 1$. What is decisive, however, is that at the time of the initial entrepreneurial insight, the entrepreneur does not necessarily have any resources at all to contribute to the productive process. The original entrepreneurial hunch responsible for the venture precedes the act of purchasing the asset. Consequently, entrepreneurship is not to be treated as a factor of production. In the real world, we are likely to observe market participants exercising entrepreneurial alertness as well as being resource-owners at the same time. For analytical purposes, however, Kirzner believes it justifiable to consider an individual who performs both functions to be two separate decision makers. If, as a result of earlier entrepreneurial decisions, an entrepreneur becomes a resource-owner, the entrepreneur can be conceived as purchasing these inputs from him- or herself. Both Kirzner and Schumpeter are quite definite that entrepreneurship does not include the control, accumulation or provision of capital. It is 'essential to note that the entrepreneurial function, though facilitated by the ownership of means, is not identical with that of the capitalist' (Schumpeter 1947: 151). A pure entrepreneur owns no capital. Institutions that facilitate the separation of ownership and control give rise to capitalists who are not entrepreneurs and to entrepreneurs who are not capitalists. And since pure entrepreneurship does not include the provision of capital (or any resources for that matter), it must necessarily follow that it does not include risk bearing either, because the risks are borne by the capitalists who lend funds to the entrepreneur. It is the capitalists who lose their money in the event of business failure. Entrepreneurs only bear risk to the extent that they may also act as their own capitalists, as they often do when they invest their own personal funds at the seed financing stage of commercial ventures. (Entrepreneurs may also supply 'reputation capital' to themselves and this too may be at stake.) Consequently, one should not expect entrepreneurs to exhibit special risk-taking propensities. Another important implication of this definition of entrepreneurship is that profit is

a reward for superior perception or alertness; it is not a reward for risk taking or uncertainty bearing.

II. Entrepreneurship versus invention

Although the entrepreneur may also be an inventor, there is no necessary connection between entrepreneurship and invention. The inventor produces new scientific and technical ideas, whereas the entrepreneur may perceive the opportunity to apply such new ideas commercially. The entrepreneur is alert to changes in technology that create profit opportunities. Entrepreneurial alertness is required to ensure that new methods of production will be introduced. The entrepreneur is thus not an inventor, but may be someone who decides to allocate resources to the exploitation of an invention. Entrepreneurship is ‘exploiting the new opportunities that inventions provide, more in the form of marketing and developing them for widespread use in the economy than developing the knowledge itself’ (Rosen 1983: 307). Entrepreneurial activity may, but need not, embody an element of scientific novelty. The alertness needed to spot profitable opportunities for trading a new product can be separated from the creativity involved in the invention of that very product. Although one has to be technically proficient in order to invent a digital camera, one does not have to be technically oriented to perceive a lucrative market for digital cameras and to notice that the sum of input prices is less than what the market is willing to pay for the digital cameras that those inputs can produce. A flesh-and-blood individual might possess both technical creativity and entrepreneurial alertness, but only the second attribute is necessary to qualify as an entrepreneur.

III. Entrepreneurship versus the formation of new firms

Scholarly enquiry into entrepreneurship in business schools (subsumed under the rubric ‘entrepreneurial studies’) often lacks rigorous theoretical foundations and precise analytical concepts. The field typically equates entrepreneurship with the creation of new firms. ‘The common assumption is that most entrepreneurial activity occurs through de novo startups’ (Shane and Venkataraman 2000: 224). The focus of enquiry is frequently upon explaining the relative performance of new businesses over time rather than the emergence, discovery and exploitation of entrepreneurial opportunities. In his early work, Schumpeter too identified entrepreneurship with the creation of new production functions by new firms rather than the

ongoing management of established firms. ‘Only someone who establishes a new business to produce a new product, or to make an old product in a new way, is to be called an entrepreneur’ (Loasby 1982b: 240).

The economic theory of entrepreneurial discovery can provide a sound intellectual framework for entrepreneurial studies and can also broaden the scope of its enquiry. From a market-process perspective, it must be emphasised that entrepreneurship may merely entail separate one-off arbitrage transactions that do not involve the founding of new business ventures. Entrepreneurial activity can occur without the involvement of firms. The creation of new firms is neither necessary nor sufficient for entrepreneurship. Buying ten units of a good at a low price in one part of the market and selling them at a higher price in another part constitutes a transitory act of entrepreneurship, but it does not require the entrepreneur to establish a hierarchical governance structure (i.e. a firm) in order to discover and seize the profit opportunity and to administer the relevant transactions. Of course, entrepreneurship might include the creation of new business organisations (including the merger of existing organisations), but this is not a defining or essential characteristic of this phenomenon. Launching a new firm and keeping it going may involve few entrepreneurial decisions, and the management of the business may even be quite routine. However, entrepreneurship can occur within the boundaries of existing firms. Indeed, the Austrian theory of the firm sees the firm as ‘an entity that organizes localized discovery procedures in the context of a structure of incomplete contracts and supporting shared mental constructs’ (Foss 1997: 194). Sautet’s (2000) notion of the ‘complex firm’ captures the idea that economic knowledge and the locus of entrepreneurial discoveries are not centralised within modern business enterprises. Rather, individual employees, who themselves display entrepreneurial qualities and have localised knowledge not shared by others, are alert to opportunities that they discover and exploit within a system of rules imposed by the hierarchical structure. The complex firm is set up by the entrepreneur–promoter as a semi-planned coordinative framework to govern productive activity in line with his or her original entrepreneurial insight. But the evolutionary growth of the firm is influenced by spontaneous entrepreneurial discoveries and indeterminate elements that were not planned or expected by anyone. Sautet evocatively refers to the ‘complex firm’ as a ‘nesting of entrepreneurs’.

IV. Entrepreneurship versus management

Because the management function is more readily observable than the entrepreneurial function, the latter is often subsumed within the former. However, the management function is actually narrower in scope than entrepreneurship. The manager is the agent who supervises the ongoing efficiency of the firm's processes of production and exchange. The manager's role is to work out how to reach the firm's production possibility loci; that is, to improve its efficiency within the limits of known technology. The standard neoclassical theory of the firm adequately describes the managerial function and the routine optimising decisions that managers make. The manager is the individual who equates marginal costs to marginal benefits in a routine (though not necessarily static) manner. As already mentioned, flesh-and-blood business people may embody entrepreneurial, managerial and other functions and may shift from one role to the other. Thus, real-world entrepreneurs must undertake many non-entrepreneurial, managerial activities because of transaction cost difficulties that impede the transfer of entrepreneurial knowledge. Consequently, the entrepreneur's managerial skills can have a significant impact on the outcome of a venture. Efficient organisation and management may be essential for entrepreneurial success. If entrepreneurial profit equals total revenue minus the sum of production and transaction costs, and if superior management is required to keep down costs, then whether a venture makes a profit or a loss may depend in part at least upon the entrepreneur's ability to manage the enterprise.

V. Entrepreneurship versus rent seeking

Following Ricketts (1987; 1992), I will define rent seeking as an attempt to challenge coercively the established structure of property rights held by people at a point in time (the 'status quo'). More specifically, in the pursuit of personal gain, the rent-seeker challenges the initially given delineation and assignment of economic rights to the attributes of assets. The essential characteristic of rent seeking is that it involves uncompensated transfers of property rights from unwilling parties. Rent seeking is value decreasing relative to (i.e. from the perspective of) the initially given property rights structure. Examples include theft, piracy, bribing judges or lobbying politicians to use the coercive powers of the state to modify the rights structure in a way that is favourable to the rent seeker. Thus, rent seeking and challenges to the status quo are not necessarily unlawful: people have a constitutional right to attempt to change the given initial

set of property rights by legitimate means through the political process. The distinction between rent seeking and entrepreneurship receives a relatively brief treatment in Kirzner's work, largely because he does not emphasise property rights issues. In Kirzner's theory of market processes, the structure of property rights is assumed to be a datum, as something given to the entrepreneur. Individuals qua entrepreneurs do not regard the property rights framework in which they act as an object of choice. In fact, according to Kirzner, the emergence of markets and the phenomenon of market entrepreneurship presuppose the existence of well-defined private property rights and other extra-market institutions. Kirznerian entrepreneurs can only operate within a given rights structure. They are alert to opportunities and gains from voluntary market exchanges that are implicit in the anterior backdrop of given property rights. Unlike rent-seekers, they pursue personal gain by trading property rights in resources through non-coercive means, and they implicitly accept the status quo framework of property rules (and prevailing definitions of what it means to own something). The status quo, of course, is not a brute objective fact but a 'subjective' state of affairs that depends upon people's rival interpretations of entitlements. People do not necessarily share the same knowledge and expectations about property rights. If entitlements are not clearly defined and agreed upon, distinguishing rent seeking from entrepreneurship is highly problematic. For example, it is difficult to determine whether an attempt to establish private rights in a resource is rent seeking or entrepreneurship when some people in a community regard that resource as an open access or communal resource while others regard the same asset as previously unowned and ripe for appropriation (Ricketts 1992: 76–77). The issues are complex and subtle. Kirzner's stipulation that entrepreneurship can take place only within an initially given set of property rules may be too restrictive and generally not necessary analytically for my purposes. All market entrepreneurship involves the creation of new ends–means frameworks. Using new means to achieve new ends can make it necessary to redefine property rights vis-à-vis other existing means. New ways of using resources create new conflicts of interest. Technological developments and the innovative ventures to which they give rise may require extending property rights to new objects or shifting existing rights. The bolder and more path breaking the innovation, the more likely this may be.

1.3 The Entrepreneurial Economy

I. Since the mid-seventies, such slogans as “the no-growth economy,” the “deindustrialization of America,” and a long-term “Kondratieff stagnation of the economy” have become popular and

are invoked as if axioms. Yet the facts and figures belie every one of these slogans. What is happening in the United States is something quite different: a profound shift from a “managerial” to an “entrepreneurial” economy. In the two decades 1965 to 1985, the number of Americans over sixteen (thereby counted as being in the work force under the conventions of American statistics) grew by two-fifths, from 129 to 180 million. But the number of Americans in paid jobs grew in the same period by one-half, from 71 to 106 million. The labor force growth was fastest in the second decade of that period, the decade from 1974 to 1984, when total jobs in the American economy grew by a full 24 million. In no other peacetime period has the United States created as many new jobs, whether measured in percentages or in absolute numbers. And yet the ten years that began with the “oil shock” in the late fall of 1973 were years of extreme turbulence, of “energy crises,” of the near-collapse of the “smokestack” industries, and of two sizable recessions. The American development is unique. Nothing like it has happened yet in any other country. Western Europe during the period 1970 to 1984 actually lost jobs, 3 to 4 million of them. In 1970, western Europe still had 20 million more jobs than the United States; in 1984, it had almost 10 million less. Even Japan did far less well in job creation than the United States.

II. Of the 40 million-plus jobs created since 1965 in the economy, high technology did not contribute more than 5 or 6 million. High tech thus contributed no more than “smokestack” lost. All the additional jobs in the economy were generated elsewhere. And only one or two out of every hundred new businesses—a total of ten thousand a year—are remotely “high-tech,” even in the loosest sense of the term. We are indeed in the early stages of a major technological transformation, one that is far more sweeping than the most ecstatic of the “futurologists” yet realize, greater even than Megatrends or Future Shock. Three hundred years of technology came to an end after World War II. During those three centuries the model for technology was a mechanical one: the events that go on inside a star such as the sun. This period began when an otherwise almost unknown French physicist, Denis Papin,* envisaged the steam engine around 1680. They ended when we replicated in the nuclear explosion the events inside a star. For these three centuries advance in technology meant—as it does in mechanical processes—more speed, higher temperatures, higher pressures. Since the end of World War II, however, the model of technology has become the biological process, the events inside an organism. And in an organism, processes are not organized around energy in the physicist’s meaning of the term.

III. Where did all the new jobs come from? The answer is from anywhere and nowhere; in other words, from no one single source. The magazine Inc., published in Boston, has printed each year since 1982 a list of the one hundred fastest-growing, publicly owned American companies more than five years and less than fifteen years old.

Being confined to publicly owned companies, the list is heavily biased toward high tech, which has easy access to underwriters, to stock market money, and to being traded on one of the stock exchanges or over the counter. High tech is fashionable. Other new ventures, as a rule, can go public only after long years of seasoning, and of showing profits for a good deal more than five years. Yet only one-quarter of the “Inc. 100” are high-tech; three-quarters remain most decidedly “low-tech,” year after year. In 1982, for instance, there were five restaurant chains, two women’s wear manufacturers, and twenty health-care providers on the list, but only twenty to thirty high-tech companies. And whilst America’s newspapers in 1982 ran one article after the other bemoaning the “deindustrialization of America,” a full half of the Inc. firms were manufacturing companies; only one-third were in services.

IV. Is there anything at all that these growth enterprises have in common other than growth and defiance of the Kondratieff stagnation? Actually, they are all examples of “new technology,” all new applications of knowledge to human work, which is, after all, the definition of technology. Only the “technology” is not electronics or genetics or new materials. The “new technology” is entrepreneurial management. Once this is seen, then the astonishing job growth of the American economy during the last twenty, and especially the last ten years can be explained. It can even be reconciled with the Kondratieff theory. The United States—and to some extent also Japan—is experiencing what might be called an “atypical Kondratieff cycle.” Since Joseph Schumpeter first pointed it out in 1939, we have known that what actually happened in the United States and in Germany in the fifty years between 1873 and World War I does not fit the Kondratieff cycle.

V. Of all the major modern economists only Joseph Schumpeter concerned himself with the entrepreneur and his impact on the economy. Every economist knows that the entrepreneur is important and has impact. But, for economists, entrepreneurship is a “meta-economic” event, something that profoundly influences and indeed shapes the economy without itself being part of it. And so too, for economists, is technology. Economists do not, in other words, have any explanation as to why entrepreneurship emerged as it did in the late nineteenth century and as it seems to be doing again today, nor why it is limited to one country or to one culture. Indeed, the

events that explain why entrepreneurship becomes effective are probably not in themselves economic events. The causes are likely to lie in changes in values, perception, and attitude, changes perhaps in demographics, in institutions (such as the creation of entrepreneurial banks in Germany and the United States around 1870), perhaps changes in education as well. Something, surely, has happened to young Americans—and to fairly large numbers of them—to their attitudes, their values, their ambitions, in the last twenty to twenty-five years. What has made possible the emergence of the entrepreneurial economy in America is new applications of management:

- to new enterprises, whether businesses or not, whereas most people until now have considered management applicable to existing enterprises only;
- to small enterprises, whereas most people were absolutely sure only a few years ago that management was for the “big boys” only;
- to non-businesses (health care, education, and so on), whereas most people still hear “business” when they encounter the word “management”;
- to activities that were simply not considered to be “enterprises” at all, such as local restaurants;
- and above all, to systematic innovation: to the search for and the exploitation of new opportunities for satisfying human wants and human needs.

As a “useful knowledge,” a techné management is the same age as the other major areas of knowledge that underlie today’s high-tech industries, whether electronics, solid-state physics, genetics, or immunology. Management’s roots lie in the time around World War I. During the last ten or fifteen years we have reversed this trend. In fact, we might now have a trend toward “deinstitutionalizing” America rather than one toward “deindustrializing” it. For almost fifty years, ever since the 1930s, it was widely believed in the United States and in Western Europe too that the hospital was the best place for anyone not quite well, let alone for anyone seriously sick. “The sooner the patient gets to the hospital, the better care we can take of him,” was the prevailing belief, shared by doctors and patients alike. In the last few years, we have been reversing this trend. We now increasingly believe that the longer we can keep patients away from the hospital and the sooner we can get them out, the better. Surely this reversal has little to do with either health care or with management. It is a reaction—whether permanent or short-lived—against the worship of centralization, of “planning,” of government which began in the 1920s

and 1930s, and which in the United States reached its peak in the Kennedy and Johnson administrations of the 1960s. However, we could not indulge in this “deinstitutionalization” in the health-care field if we had not acquired the competence and the confidence to manage small institutions and “non-businesses,” that is, health-care institutions. All told we are learning that management may well both be more needed and have greater impact on the small entrepreneurial organization than it has in the big “managed” one. Above all, management, we are learning now, has as much to contribute to the new, the entrepreneurial enterprise, as to the existing, ongoing “managerial” one. To take a specific example, hamburger stands have been around in the United States since the nineteenth century; after World War II they sprang up on big-city street corners. But in the McDonald’s hamburger chain—one of the success stories of the last twenty-five years—management was being applied to what had always been a hit-and-miss, mom-and-pop operation. McDonald’s first designed the end product; then it redesigned the entire process of making it; then it redesigned or in many cases invented the tools so that every piece of meat, every slice of onion, every bun, every piece of fried potato would be identical, turned out in a precisely timed and fully automated process. Finally, McDonald’s studied what “value” meant to the customer, defined it as quality and predictability of product, speed of service, absolute cleanliness, and friendliness, then set standards for all of these, trained for them, and geared compensation to them. Management is the new technology (rather than any specific new science or invention) that is making the American economy into an entrepreneurial economy. It is also about to make America into an entrepreneurial society. Indeed, there may be greater scope in the United States—and in developed societies generally—for social innovation in education, health care, government, and politics than there is in business and the economy. And again, entrepreneurship in society—and it is badly needed—requires above all application of the basic concepts, the basic techné, of management to new problems and new opportunities. This means that the time has now come to do for entrepreneurship and innovation what we first did for management in general some thirty years ago: to develop the principles, the practice, and the discipline.

1.4 Importance of Entrepreneurship

Entrepreneurship offers the following benefits to an Organization:

I. Development of managerial capabilities:

- ✓ The biggest significance of entrepreneurship lies in the fact that it helps in identifying and developing managerial capabilities of entrepreneurs. An entrepreneur studies a problem, identifies its alternatives, compares the alternatives in terms of cost and benefits implications, and finally chooses the best alternative.
- ✓ This exercise helps in sharpening the decision making skills of an entrepreneur. Besides, these managerial capabilities are used by entrepreneurs in creating new technologies and products in place of older technologies and products resulting in higher performance.

II. Creation of organizations:

- ✓ Entrepreneurship results into creation of organizations when entrepreneurs assemble and coordinate physical, human and financial resources and direct them towards achievement of objectives through managerial skills.

III. Improving standards of living:

- ✓ By creating productive organizations, entrepreneurship helps in making a wide variety of goods and services available to the society which results into higher standards of living for the people.
- ✓ Possession of luxury cars, computers, mobile phones, rapid growth of shopping malls, etc. are pointers to the rising living standards of people, and all this is due to the efforts of entrepreneurs.

IV. Means of economic development:

Entrepreneurship involves creation and use of innovative ideas, maximization of output from given resources, development of managerial skills, etc., and all these factors are so essential for the economic development of a country.

1.5 Classification & Types of Entrepreneurs of Entrepreneurs:

Classifying entrepreneurs into various categories is a tricky issue. The taxonomy of entrepreneurs can be carried out in various ways. Entrepreneurs can be classified on the basis of their commitment to innovate something new, their socio-cultural backgrounds, scale or potential of operations, or timing of venture creation in relation to their professional lifespan.

What must be kept in mind is the reason behind the classification. Differentiating between entrepreneurs can be done to differentially incentivize certain groups, to study difference in various groups, or to study factors and consequence of entrepreneurship in different populations.

I. Classification Based on the Level of Commitment to Start Something New

Depending upon the level of willingness to create innovative ideas, there can be the following types of entrepreneurs:

A/ Innovative Entrepreneurs:

These entrepreneurs have the ability to think newer, better and more economical ideas of business organization and management. They are the business leaders and contributors to the economic development of a country.

Inventions like the introduction of a small car 'Nano' by Ratan Tata, organized retailing by Kishore Biyani, making mobile phones available to the common man by Anil Ambani are the works of innovative entrepreneurs.

B/ Imitating Entrepreneurs:

These entrepreneurs are people who follow the path shown by innovative entrepreneurs. They imitate innovative entrepreneurs because the environment in which they operate is such that it does not permit them to have creative and innovative ideas on their own. Such entrepreneurs are found in countries and situations marked with weak industrial and institutional base which creates difficulties in initiating innovative ideas.

In our country also, a large number of such entrepreneurs are found in every field of business activity and they fulfill their need for achievement by imitating the ideas introduced by innovative entrepreneurs.

Development of small shopping complexes is the work of imitating entrepreneurs. All the small car manufacturers now are the imitating entrepreneurs.

C/ Fabian Entrepreneurs:

The dictionary meaning of the term 'fabian' is 'a person seeking victory by delay rather than by a decisive battle'. Fabian entrepreneurs are those individuals who do not show initiative in visualizing and implementing new ideas and innovations, rather they wait for some development which would motivate them to initiate unless there is an imminent threat to their very existence.

D/ Drone Entrepreneurs:

The dictionary meaning of the term 'drone' is 'a person who lives on the labor of others'. Drone entrepreneurs are those individuals who are satisfied with the existing mode and speed of business activity and show no inclination in gaining market leadership.

In other words, drone entrepreneurs are die-hard conservatives and even ready to suffer the loss of business.

E/ Social Entrepreneurs:

Social entrepreneurs drive social innovation and transformation in various fields including education, health, human rights, workers' rights, environment and enterprise development. They undertake poverty alleviation objectives with the zeal of an entrepreneur, business practices and dare to overcome traditional practices and to innovate.

II. Classification Based on the Timing of Venture Creation

Based on the timing of venture creation, entrepreneurs are classified as early start-ers, experienced and mature.

A/ Early Starters:

An early starter starts the venture with little or no full-time work experience. Often, early starters are from business families and have participated in the family business. An early starter is generally convinced of the great potential of his/her business idea and feels that the opportunity may cease to exist if he/she waits too long.

B/ Experienced:

This type of entrepreneur has spent a few years working in the family business or in some other large company. Usually, the venture is related to the type of work the entrepreneur was previously engaged in. The entrepreneur brings a lot of experience, skills, and personal credibility into the venture.

C/ Mature:

A lot of very senior professionals, some at the level of CEO, are quitting their jobs to start their own ventures. This is probably because they have very high confidence in their abilities and have a desire to do things in a way that may not be totally acceptable to their erstwhile employers.

III. Classification Based on Socio-cultural Variables:

Different types of entrepreneurs based on socio-cultural variables are discussed here.

A/ First-Generation Entrepreneurs:

This category consists of those entrepreneurs whose parents or family have not been in business and were into salaried service. The booming economy of our country has led to a multitude of business opportunities, and with deregulation, it has become easier to set up businesses. Also, with a change in the mindset of the middle class, it is now more acceptable to become an entrepreneur.

B/ Entrepreneurs from Business Families:

Traditionally, there have been a few socio-ethnic groups who have dominated the business scene in most of the developing countries. It is argued that entrepreneurship becomes easier for someone from a business family or from a business community as there is a very solid support structure to help in times of need. But entrepreneurial success needs far more than just that.

C/ Minority Entrepreneurs:

There are many small ethnic groups that have traditionally not ventured into business. It has become important for them to venture out and create lasting enterprises. They will serve as examples for the rest of their community. Distinctly low levels of entrepreneurial activity are witnessed among the tribes of our continent, the hill people of the Sub Saharan countries and among some socio-economically backward classes.

D/ Women Entrepreneurs:

Women as entrepreneurs have been a recent phenomenon in our continent. The social norms in Africa had made it difficult for women to have a professional life. Now this has changed.

Progressive laws and other incentives have also boosted the presence of women in entrepreneurial activity in diverse fields.

IV. Classification Based on Entrepreneurial Activity:

Based on entrepreneurial activity, entrepreneurs are classified as novice, serial entrepreneur, and portfolio entrepreneur.

A/ Novice:

A novice is someone who has started his/her first entrepreneurial venture. Not to be confused with an early starter, a novice can also be a 50 year old with over 25 years of experience in the industry.

B/ Serial Entrepreneur:

A serial entrepreneur is someone who is devoted to one venture at a time but ultimately starts many. It is the process of starting that excites the starter. Once the business is established, the serial entrepreneur may lose interest and think of selling and moving on.

C/ Portfolio Entrepreneur:

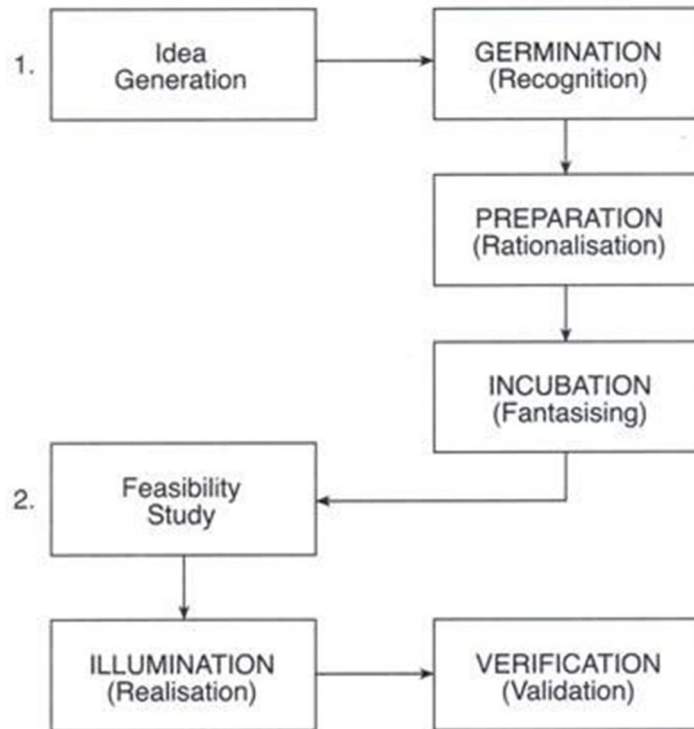
A portfolio entrepreneur starts and runs a number of businesses. It may be a strategy of spreading risk or it may be that the entrepreneur is simultaneously excited by a variety of opportunities. Also, the entrepreneur may see some synergies between the ventures.

1.6 Entrepreneurial Process

Entrepreneurship is a process, a journey, not the destination; a means, not an end. All the successful entrepreneurs like Bill Gates (Microsoft), Warren Buffet (Hathaway), Gordon Moore (Intel) Steve Jobs (Apple Computers), Jack Welch (GE) GD Birla, Jamshedji (Tata) and others all went through this process.

To establish and run an enterprise it is divided into three parts – the entrepreneurial job, the promotion, and the operation. Entrepreneurial job is restricted to two steps, i.e., generation of an idea and preparation of feasibility report.

For this particular course purpose, we shall restrict ourselves to only these two aspects of entrepreneurial process.



1. Idea Generation:

To generate an idea, the entrepreneurial process has to pass through three stages:

a. Germination:

This is like seeding process, not like planting seed. It is more like the natural seeding. Most creative ideas can be linked to an individual's interest or curiosity about a specific problem or area of study.

b. Preparation:

Once the seed of interest curiosity has taken the shape of a focused idea, creative people start a search for answers to the problems. Inventors will go on for setting up laboratories; designers will think of engineering new product ideas and marketers will study consumer buying habits.

c. Incubation:

This is a stage where the entrepreneurial process enters the subconscious intellectualization. The subconscious mind joins the unrelated ideas so as to find a resolution.

2. Feasibility study:

Feasibility study is done to see if the idea can be commercially viable. It passes through two steps:

a. Illumination:

After the generation of idea, this is the stage when the idea is thought of as a realistic creation. The stage of idea blossoming is critical because ideas by themselves have no meaning.

b. Verification:

This is the last thing to verify the idea as realistic and useful for application. Verification is concerned about practicality to implement an idea and explore its usefulness to the society and the entrepreneur.

Chapter Two – Theories of entrepreneurship

2.1 ‘Early’ theories of entrepreneurship

My treatment of early theories of entrepreneurship will be fairly brief, since much of this literature has been summarised by other authors. I will group these theories by theme rather than chronologically, unlike Hébert and Link (2006), for example, in the updated version of their ‘classic’ enquiry into the identity of the entrepreneur.

1. Arbitrage and the bearing of risk and uncertainty. Richard Cantillon (1755) stressed the importance of the entrepreneur as an arbitrageur or speculator, who conducts all exchanges and bears risk as a result of buying at certain prices and selling at uncertain ones. Cantillon’s is a risk theory of profit: anyone who receives an uncertain income can essentially be regarded as an entrepreneur.
2. Co-ordination of factors of production. According to Jean-Baptiste Say (1828), the chief contribution of the entrepreneur is to combine and co-ordinate factors of production. The entrepreneur stands at the center of the economic system, directing and rewarding the various factors of production, and taking the residual as profit.
3. Innovation and creative destruction. According to Josef Schumpeter (1934, 1939), entrepreneurship entails innovation. The entrepreneur does not operate within conventional technological constraints, making small gradual changes to existing production methods. Instead, he or she develops new technologies or products that make discrete discontinuous changes which shift the paradigm altogether, breaking organisational routines and driving economic development (Santarelli and Pesciarelli, 1990). In Schumpeter’s words, the entrepreneur as innovator is responsible for ‘the doing of new things or the doing of things that are already being done in a new way’. This could involve:
 - (i) the creation of a new product;
 - (ii) a new method of production;
 - (iii) the opening of a new market;
 - (iv) the capture of a new source of supply; or
 - (v) a new organisation of industry.
4. Leadership and motivation. In stark contrast to Schumpeter, others have claimed that a defining feature of entrepreneurs is that they bring about changes of a gradual nature to existing

products and processes, through a combination of leadership, motivation, the ability to resolve crises and risk-taking (Leibenstein, 1968).

5. Personal or psychological traits. This line of thought relates entrepreneurship to the possession of special innate personal characteristics. While not exhaustive, the above list includes many of the most influential 'traditional' views about entrepreneurs. The brevity of this overview was deliberate.

2.2. Modern Economic Theory

2.2.1 The occupational choice model of entrepreneurship I: homogeneous agents

Modern economic theories of entrepreneurship differ in at least two important respects from those described above. Perhaps the most important distinction relates to the dominance of the utility maximising paradigm in modern economic research. Modern economic theories take as their starting point the Knightian premise that individuals do not have to be entrepreneurs. They can choose between entrepreneurship and some outside option (usually taken to be paid employment); and they choose the occupation that offers them the greatest expected utility. Most theories treat occupational choice as a discrete, rather than a continuous, decision.

A second distinctive feature of modern economic theories of entrepreneurship is that they make their simplifying assumptions explicit. These assumptions usually include the existence of competitive product markets, known technology, and price-taking workers and entrepreneurs. In many cases these assumptions are inessential to the results, and merely simplify the analysis. The present section analyses entrepreneurship as an occupational choice when agents are homogeneous. It first analyses the simplest cases, and then introduces additional layers of complexity (and realism) by introducing risk and risk aversion. The simplest 'static' models, in which events take place in a single period, are discussed first. This is followed by a treatment of 'dynamic' models, in which events unfold over several periods.

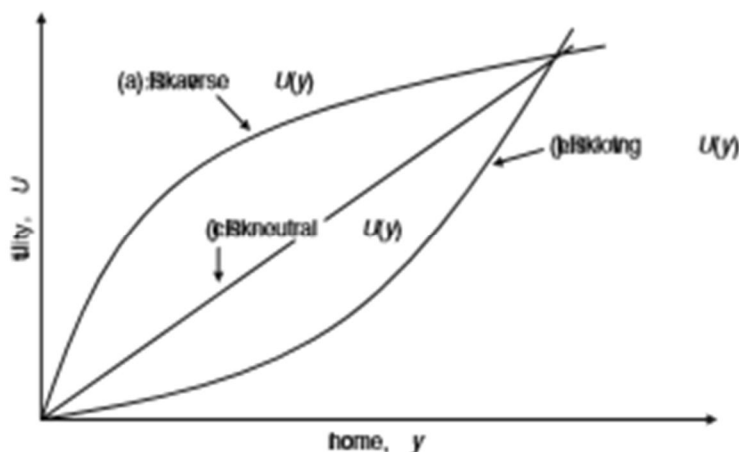


Figure 2.1 Utility functions

i. Definitions of risk aversion and risk

To commence, consider a utility function $U(y)$ which is an increasing function of income, y . In principle, utility functions can take several shapes: three are illustrated in Figure 2.1. Utility function (a) is a concave function of income. While extra units of income increase utility, they increase it by progressively smaller amounts. This utility function is also said to embody risk aversion. Individuals with utility functions exhibiting a greater degree of curvature than in (a) are said to be more risk-averse. Technically, this utility function has a positive first and a negative second derivative with respect to y . More risk-averse people are willing to pay a higher insurance premium to avoid risk than their less risk-averse counterparts.

Utility function (b) in Figure 2.1 is a convex function of income. Extra units of income increase utility by progressively greater amounts. This utility function is said to embody risk-loving preferences. Individuals with utility functions exhibiting a greater degree of curvature are said to be more risk-loving. Technically, this utility function has positive first and second derivatives with respect to y . Utility function (c) is linear in income. It embodies risk neutrality. As the name suggests, risk-neutral people are indifferent to risk. A wide array of evidence suggests that in the real world, most individuals, including entrepreneurs, are risk-averse. This debunks the popular view that entrepreneurs are gamblers, and is consistent with evidence that entrepreneurs' behaviour is better described by moderate and calculated risk taking than outright gambling. Thus entrepreneurs 'enjoy the excitement of a challenge, but they don't gamble. Entrepreneurs

avoid low-risk situations because there is a lack of challenge and avoid high-risk situations because they want to succeed. This means that as they become wealthier, they become less reluctant to gamble a fixed sum. DARA (decreasing absolute risk aversion) plays a key role in some of the models of entrepreneurship analysed. It is also helpful to have a precise definition of 'an increase in risk'. Two useful and general definitions are second-order stochastic dominance (SOSD) and meanpreserving spread (MPS).

Simple static models

The simplest static models treat an economy without risk, where individuals choose between working for a wage of w and producing output independently as an entrepreneur in return for profit, π . If $\pi > w$, workers switch into entrepreneurship. By the laws of supply and demand, the extra output decreases the price it is sold for, reducing π until it comes into equality with w . Conversely, π cannot be less than w because then entrepreneurs would quit, reducing aggregate output and thereby increasing the price until equality was restored. It follows immediately that $w = \pi$ is an equilibrium condition in this simple case. Likewise, any exogenous increase in w (caused by technological change, for example) will decrease the equilibrium number of entrepreneurs (de Wit, 1993). Richer versions of this simple model of homogeneous agents introduce risk. Risk can emanate from various sources. Entrepreneurs may be unsure about the demand for their good, their ability to produce, or future costs of production (Wu and Knott, 2006). Although employees can also face some risk, through income variation and redundancy for example, entrepreneurs face more variable income than workers do as well as higher business closure rates (see chapters 13 and 14). Most researchers assume for simplicity that entrepreneurs face some kind of idiosyncratic risk to their profits, whereas employees all face a certain wage, w . The assumption of perfect certainty in paid employment is usually innocuous, and can be relaxed without affecting analytical predictions. It will also be assumed that entrepreneurs cannot completely diversify or sell their risk. This also appears to be a reasonable assumption. Markets for private unemployment, accident and sickness insurance are limited and prone to moral hazard problems. Few entrepreneurs have access to stock markets to share risk, and real world capital markets are imperfect, undermining entrepreneurs' efforts to smooth consumption in the face of income risk. It might be thought that, given risk aversion among entrepreneurs, an increase in risk in entrepreneurship would

necessarily decrease the equilibrium number of entrepreneurs. In fact, the opposite turns out to be the case, if entrepreneurs can choose output once risky demand outcomes are revealed. The reason is that risk can provide upside potential as well as downside outcomes, making riskier markets more attractive and hence liable to market entry even by risk-averse entrepreneurs (Sheshinski and Drèze, 1976). The possibility that occupations offering high upside potential can attract individuals seeking rare but highly profitable opportunities was recognised over half a century ago (Roy, 1951). In practice, able individuals are indeed more likely to try start-ups in risky markets like software development than in 'safe' markets like hairdressing (Bhide, 2000). Bhide contends that entrepreneurs who become very successful in sectors with highly skewed returns do not necessarily need to have special insights or a novel technological discovery. They might merely possess superior information and sell an already existing service or product more effectively than the competition. He concludes that 'given...limited endowments, profitable start-ups tend to cluster in small, uncertain market niches' (Bhide, 2000). Kanbur (1979) studied the effects of greater risk aversion on the equilibrium number of entrepreneurs. Kanbur's model generates two hypotheses:

- (i) if labour is hired after the outcome of the random shock is observed, an increase in absolute risk aversion decreases the equilibrium number of entrepreneurs, since risk-averse individuals avoid risky occupations;
- (ii) if labour is hired before the outcome of the random shock is observed, an increase in absolute risk aversion has an ambiguous effect on the number of entrepreneurs.

Prediction (i) appears to give some theoretical backing for the popular view that Europe has less high-value-adding entrepreneurship than the USA because Europeans are more risk-averse than Americans are. However, there are at least two reasons to treat this argument with scepticism. First, most entrepreneurs who hire workers in practice do so continuously, i.e. before risk is resolved. That makes Kanbur's hypothesis (ii) the relevant case – but this case is the theoretically ambiguous one. Second, the Kanbur model assumes that every individual is identical, and that all entrepreneurs hire workers. These assumptions appear unrealistic and are relaxed in some of the models discussed below.

Dynamic models

The models discussed so far assume costless switching between occupations. Thus if entrepreneurship becomes attractive relative to paid employment, workers are assumed to move immediately into entrepreneurship; the converse also applies. However, individuals might incur costs of switching occupation. These costs could be non-pecuniary involving, for example, the sudden loss of a pleasant compensating differential, disruption to an accustomed lifestyle, a feeling of rootlessness, stress from change, or stigma from failure (Gromb and Scharfstein, 2002; Landier, 2004). Or they could be economic in nature involving, for example, lost sector-specific experience, costs of raising start-up capital (if entering entrepreneurship), or retraining costs (if entering paid employment). Switching costs might also relate to exit barriers caused by incurring sunk costs of capital with limited resale value, prior commitments to customers, or a desire by entrepreneurs to avoid sending an adverse signal of ability by abandoning their ventures (Boot, 1992).

Dixit (1989) showed that risk together with sunk costs can give agents an option value of waiting before switching. This reduces the total amount of entry and exit that occurs – as conditions have to become very bad before entrepreneurs close their business and relinquish their sunk costs, or very favourable before they are willing to incur the risk of jeopardising their assets by entering the market. Risk generates an ‘option value’ of remaining in the present occupation and deferring a costly switch. Only when average incomes in entrepreneurship reach some upper ‘trigger point’ will people become entrepreneurs. And they will only leave entrepreneurship in the presence of the adjustment cost if incomes drop to some lower trigger point. Between these two trigger points individuals remain in their current occupation (Dixit and Rob, 1994). Consequently, there may be hysteresis (i.e. path-dependence) in occupational choice. Individuals may remain in entrepreneurship even if the returns there at a given instant are less than those available in an alternative occupation. It is rational to remain in the occupation not only because of the switching cost, but also because there is an option value to wait and see if conditions in the currently unfavourable occupation improve. Only if this option value becomes sufficiently small does switching become worthwhile. Dixit and Rob (1994) went on to show that a socially suboptimal amount of switching takes place in equilibrium.

2.2.2 The occupational choice model II: heterogeneous ability – the Lucas (1978) model

In practice, it is likely that entrepreneurs differ from employees and among themselves in terms of their innate 'entrepreneurial ability'. Lucas (1978) was one of the first researchers to trace out the economic implications of heterogeneous entrepreneurial ability.

The Lucas model

Ability in entrepreneurship might derive from human capital (van Praag, 2005), idiosyncratic leadership qualities (Leibenstein, 1968) or judgement (Casson, 2003), among other possible sources. Whatever its provenance, to fix ideas and keep the exposition simple I will just assume that everybody, whether an entrepreneur or not, has some innate ability which describes how well they would perform in entrepreneurship were they to become an entrepreneur. Ability is measured as a single-dimensional quantity, x . The lowest ability in the population is \underline{x} , while the highest is \bar{x} . Denote the relative frequency of individuals with an entrepreneurial ability of x by $f(x)$, and the cumulative relative frequency by $F(x)$. It is also assumed that abilities are fixed and known with certainty by each individual. Jovanovic (1982) among others has relaxed this assumption, in a model where entrepreneurs learn about their x by observing their performance in entrepreneurship. Lucas (1978) assumed that x scales up an entrepreneur's output of q to give net profit of $\pi(x) = xq - c$, where c is the cost of using capital and labour to produce q (similar results obtain if x scales down the entrepreneur's costs, but it is simplest to work with the output assumption). The output price is normalised to unity and all people are taken to be risk-neutral. It follows directly that all and only individuals with $x \geq \tilde{x}$ will become entrepreneurs, where \tilde{x} is the identity of the 'marginal entrepreneur', defined as the person who is indifferent between the two occupations: $\pi(\tilde{x}) = w$. (2.1) An implication of this 'fundamental' equation of entrepreneurial occupational choice is that there are a total of $1 - F(\tilde{x})$ entrepreneurs; the remaining $F(\tilde{x})$ people work for the entrepreneurs as employees. This equilibrium is illustrated in Figure 2.2. A property of the Lucas production function xq is that entrepreneurs' demands for labour and capital are greater among those with higher x . That is, able entrepreneurs run larger firms, irrespective of whether size is defined in terms of employment or capital assets. This furnishes another reason why the ablest people become entrepreneurs.

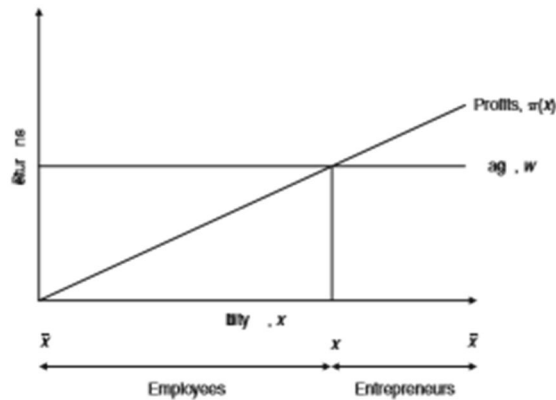


Figure 2.2 Occupational choice with heterogeneous entrepreneurial ability

Operating a firm enables able people to spread their ability over a larger scale and so reap greater returns. Lucas (1978) obtained further results by making a dynamic extension to his model. He asked how entrepreneurs adjust their demand for factors of production (capital and labour) when the stock of capital increases as the economy develops. A key parameter in this regard is the technical elasticity of substitution, σ , which describes the sensitivity of entrepreneurs' chosen capital-labour ratio to changes in the relative prices of capital and labour. Assuming that firm growth rates are independent of firm size, Lucas showed that if σ is less than (greater than) (equal to) unity, increases in per capita capital in the economy decrease (increase) (leave unchanged) the equilibrium number of entrepreneurs, and increase (decrease) (leave unchanged) average firm size. The intuition behind this result is as follows. If the supply of capital increases, (a) labour becomes more productive and (b) the price of capital decreases relative to that of labour (i.e. the wage). Effect (a) increases the demand for labour while effect (b) decreases it. But if $\sigma < 1$, effect (b) is modest relative to effect (a), since relative factor usage does not respond much following the change in their relative prices. So the demand for labour rises overall, increasing the wage, and so encouraging marginal entrepreneurs to become employees. That increases \bar{x} and thereby also the average size of firms. It is interesting to interpret Lucas' dynamic result in terms of a prediction about future trends in the fraction of the workforce who are entrepreneurs. Empirical estimates consistently point to an elasticity of substitution of less than unity. Given also that capital per head tends to grow over time (Maddison,

1991), Lucas' model therefore predicts that the fraction of entrepreneurs will inexorably decline over time, while the average firm size and industrial concentration will both inexorably increase. Lucas (1978) concluded his article with an anecdote about a small, family-owned ('entrepreneurial') restaurant he visited on vacation. He conjectured that this organisational form would eventually come to be replaced by a large franchise outlet ('paid employment') as an inevitable consequence of rising real wages. More generally, one can observe the progressive disappearance of small, owner-managed convenience stores in Britain and America and the reallocation of their labour towards large supermarket chains. Consistent with these arguments, much of the observed productivity gains in the US retail sector in the 1990s involved the entry of new establishments associated with large multi-unit firms, and the exit of small independents (Haltiwanger, 2006).

2.3.2 Criticisms of the Lucas model

Despite its elegance and profound influence on the economics of entrepreneurship, Lucas' (1978) model can be criticised on several grounds. One technical objection is the assumption of Gibrat's Law, which underlies the dynamic variant of Lucas' model. Recent studies have cast doubt on the applicability of this 'Law', finding that firm growth rates are actually not invariant to firm size (see chapter 11). A more fundamental criticism of Lucas' model is that it neglects technological change, which is arguably a more important source of macroeconomic growth than changes in the capital stock. Innovation and technological change may have endowed new entrepreneurial ventures with a competitive advantage over their larger counterparts in some industries, such as ICT (Acs and Audretsch, 1991). To the extent that this is true, more rather than less entrepreneurship would be expected to emerge as economies develop. A related problem is that Lucas' model is highly aggregated and simplified, glossing over important industry composition effects. This is likely to be important in view of the concentration of entrepreneurs in particular industry sectors (see chapter 4). In particular, rising levels of prosperity often translate into greater demand for services (e.g. personal and customised services) that entrepreneurs are particularly efficient at supplying. Furthermore, Lucas did not define entrepreneurial ability, x , precisely, taking it to be exogenous with an unexplained provenance. As noted above, it is common for researchers to interpret ability in terms of human capital, such as schooling and experience. Unfortunately, the empirical evidence does not point

to an unambiguous relationship between human capital and selection into entrepreneurship. Occasionally, ability is defined in a more specific manner, for example as the ability to predict and adjust to idiosyncratic changes in consumer tastes, as in Takii (2008). However, this definition is more difficult to operationalise empirically. Another problem is that if entrepreneurs learn over time, it may be inappropriate to treat entrepreneurial managerial ability as fixed and exogenous (Otani, 1996). A simple test of whether entrepreneurial ability is fixed or improves with learning can be performed by estimating how entrepreneurs' productivities (a proxy for ability) vary with the number of firms in a locality. If abilities are fixed, then more firms in a locality implies lower average entrepreneurial ability. But if entrepreneurs can learn from each other, thereby enhancing their ability, then more firms in a locality might imply higher average entrepreneurial ability. Measuring ability as average firm productivity in a sample of Italian manufacturing firms, Guiso and Schivardi (2005) detected a significant positive relationship between average firm productivity and the number of firms in the entrepreneur's locality, supporting the learning hypothesis and rejecting Lucas' static ability hypothesis. These findings may imply that instead of trying to reduce entry barriers, governments should promote entrepreneurial clusters since these can efficiently facilitate entrepreneurial learning and productivity.

2.2.3 The occupational choice model III: heterogeneous risk attitudes – the Kihlstrom and Laffont (1979) model

The economic implications of this question have been analysed by Kihlstrom and Laffont (1979) (hence forth KL79). In Kihlstrom and Laffont's own words, their model is 'a formalisation, for a special case, of Knight's discussion of the entrepreneur' (1979). This is because Knight proposed diversity among individuals with regard to confidence in their judgement to run firms: those who are 'confident and venturesome "assume the risk" or "insure" the doubtful and timid by guaranteeing to the latter a specified income in return for an assignment of the actual results' (Knight, 1921). KL79 abstract from unequal managerial abilities: risk attitude is the only source of heterogeneity in their model. As noted earlier in the chapter, more risk-averse individuals are willing to pay a premium in order to insure themselves against risk. Put another way, faced with the choice between receiving a safe return in paid employment, w , and a risky return in entrepreneurship, a more risk-averse person is likelier to take the safe option. KL79 proved that if there is a continuum of agents differentiated only by their risk attitude, only the least risk-

averse will become entrepreneurs. This can be understood within the usual occupational choice framework in terms of a marginal entrepreneur who is indifferent between risky entrepreneurship and safe paid employment. Everyone who is less risk-averse than the marginal entrepreneur becomes an entrepreneur, and everyone who is more risk-averse becomes an employee (see Figure 2.2, where x is now interpreted as an inverse measure of risk aversion). To be a viable occupation in this model, entrepreneurship must pay a risk premium. This is only attractive to the least risk-averse; it is insufficient to compensate more risk-averse individuals. The prediction that less risk-averse individuals are more likely to become entrepreneurs is intuitive and has received independent empirical support. KL79 went on to derive several further results from their model. First, more risk averse entrepreneurs are predicted to operate smaller firms, i.e. use less labour than less risk-averse entrepreneurs, under reasonably general conditions. Second, a general increase in individual risk aversion reduces the equilibrium wage. This is implied by the previous two results, because greater risk aversion decreases the demand for labour by each entrepreneur and increases the equilibrium number of employees. Both changes reduce the aggregate demand for labour and hence w (cf. Kanbur, 1979). If all individuals were risk-neutral in the KL79 model, industry equilibrium would be Pareto efficient. That is, there would be no allocations that could make one individual better off without making another individual worse off. However, when some individuals are risk-averse, three types of inefficiency can arise. First, maximisation of aggregate output requires all firms to produce the same output when the production function is concave. However, entrepreneurs with heterogeneous risk aversion operate firms of different sizes, as noted above. Second, individuals could be made better off if risks were shared, but there is no mechanism for facilitating this. Third, in general the wrong number of individuals become entrepreneurs. On the one hand risk aversion causes too few individuals to become entrepreneurs (from the stand point of efficiency), but on the other hand risk aversion causes too small a demand for labour, reducing w and so causing too many individuals to choose entrepreneurship. In general, the two effects will offset each other and the net effect on efficiency cannot be predicted without further information about tastes and technology. For example, in the special case where all individuals are equally risk-averse, it can be shown that there will be too many entrepreneurs in equilibrium. Another special case is constant returns-to-scale technology, under which only one firm is optimal, compared to the greater number that would emerge in KL's competitive equilibrium. One way of enhancing efficiency would be to introduce a risk-sharing

mechanism such as a stock market (Kihlstrom and Laffont, 1983; Grossman, 1984). For example, in the context of international trade with foreigners who have a comparative advantage in entrepreneurship-rich goods, Grossman (1984) argues that establishing risk-sharing mechanisms to stimulate domestic entrepreneurship is a better solution than imposing welfare-reducing tariffs or other trade restrictions on foreign entrepreneurs. However, a problem with the specific solution of a stock market to share risks is that it is likely to be impractical for small enterprises. The high fixed costs incurred by a stock market listing are likely to deter small firms from diversifying their risks in this way. One might also ask whether investors can write financial contracts to insure risk averse entrepreneurs. In fact, standard principal-agent models in microeconomics predict that variable returns are generally required to elicit the high levels of discretionary non-contractible entrepreneurial effort needed to make ventures succeed. If individuals faced a fixed return irrespective of what they do, they would have incentives to economise on privately costly discretionary effort. This is a theme which will recur several times in this book. The implication is that it can be optimal for lenders to write contracts that avoid fully insuring entrepreneurs (Keuschnigg and Nielsen, 2004b; Rampini, 2004). With regard to partial insurance on the other hand, the results are more subtle and surprisingly far-reaching, as an important paper by Newman (2007) demonstrates. Newman envisages an insurance company offering entrepreneurs a predetermined and relatively smooth income stream in return for entrepreneurs' risky stream of profits. Entrepreneurs still have to bear some risk, in order to induce them to supply effort; but they receive partial insurance through the less risky income stream provided by the insurer. Newman (2007) contends that the conceptually modest extension of partial income insurance creates a serious conceptual problem for the KL79 model, since he shows it implies that the poorest, and hence the most risk-averse individuals (under DARA) become the entrepreneurs, while the wealthy work for them as their employees! The rationale underlying this counter-intuitive result is that it is easier for an insurance company to incentivize poor individuals to exert effort via an income-smoothing scheme than the wealthy. Poor individuals are more risk-averse, so it is cheaper for the insurance company to devise an income stream which provides the correct incentives for them to exert effort in entrepreneurship. In contrast, wealthy people need to bear a large amount of risk under partial insurance in order to induce them to supply effort – and that can make entrepreneurship expensive and unattractive for these agents relative to 'safe' paid employment. Newman (2007) claims that the preposterous

prediction that wealthy people work for poor entrepreneurs calls into question any theory of entrepreneurship based on heterogeneous risk attitudes in which entrepreneurs' primary role is to insure workers. As he put it, 'The fragility of this theory's [KL79's] empirical predictions suggests that we probably should look elsewhere for explanations of the roles and causes of entrepreneurship' (Newman, 2007). However, there are two limitations to Newman's contention. First, if risk attitudes are independent of wealth, then KL79's analysis continues to apply regardless of whether entrepreneurs can be insured. And even if risk attitudes are not independent of wealth, a private market that insures entrepreneurs' incomes is not guaranteed to exist. In practice, insurance for business owners tends to be against specific risks (e.g. loss or damage of business equipment, or travel insurance), and not of the form Newman studied, which has insurers claiming entrepreneurs' payoffs in return for payouts of a partially smoothed stream of income. One reason why Newman's insurance system is not observed is that there are obvious incentives for entrepreneurs to under-report their incomes to the insurers. If enough entrepreneurs did this, an income-transfer system of this kind would quickly become infeasible. With a missing market for income insurance, one immediately returns to the world of KL79.

2.3 The theory of entrepreneurial discovery

2.3.1 Introduction

The theory of entrepreneurial discovery is the most widely accepted conception of entrepreneurship among market-process theorists. In line with the broader research programme within which it is embedded, this approach is distinguished by its focus upon the nature of competitive processes, market disequilibria, the role of knowledge, expectations and learning in the operation of markets, the nature and significance of entrepreneurial discovery, and the comparative effectiveness of alternative institutional frameworks for evoking entrepreneurship. Kirzner's scientific contributions on the entrepreneurial function and the institutional conditions for economic development are central to a more sophisticated understanding of entrepreneurial capitalism and the dynamic adjustment processes that coordinate economic activities in market economies. His entrepreneurial theory of market processes supplies the 'disequilibrium foundations of economic analysis' (Boettke and Rizzo 1995: xiv). It can also be argued that Kirzner's concept of entrepreneurial alertness is a common thread that runs through many of the diverse notions of the entrepreneurial function offered in the economics literature. The scope of

influence of Kirzner's theory of entrepreneurship is not limited to the disciplinary boundaries of economics. Some business administration scholars have employed his theory (in conjunction with other approaches) to construct a robust conceptual framework for the field of 'entrepreneurial studies' and to isolate the field's distinctive contribution, which they identify as the investigation of the existence, discovery and exploitation of entrepreneurial opportunities (Shane and Venkataraman 2000). There is also an emerging stream of empirical research in entrepreneurial studies that applies Kirzner's notion of entrepreneurial alertness and tests for differences in the informational cues and learning strategies used by entrepreneurs and managers in spotting profit opportunities (Kaish and Gilad 1991; Busenitz 1996). The marketing and business strategy literatures have also drawn insights from Kirzner's theory of entrepreneurial discovery (e.g. Jacobsson 1992). In particular, the strategic management literature on firms' capabilities emphasises themes, such as knowledge problems, learning processes and entrepreneurship, which have a Kirznerian and Hayekian flavour. Similarly, recent contributions to the incipient Austrian marketprocess theory of the firm also draw on Hayek's seminal work and Kirzner's notion of entrepreneurial behaviour in order to explain why firms exist and to shed light on the boundaries and internal organisational structure of businesses. This chapter fleshes out the key implications of Kirzner's theory of entrepreneurship for how and why markets work. It sets out the fundamental ideas on the entrepreneurial function that are required for subsequent chapters on the psychological determinants of entrepreneurship and its institutional and cultural foundations. Of particular interest are the causal factors that provide scope for entrepreneurship. The emphasis here is on the role of imperfect coordination between market transactions that arises because of a lack of mutual awareness among buyers and sellers. The chapter pays close attention to the non-deployable and tacit quality of entrepreneurial alertness and its other distinctive characteristics. We need to appreciate its nature fully if we are to be able to explain the effects of different institutional rules and economic policies on entrepreneurship. The closing section considers in more detail Kirzner's conception of the market process and his claim that markets have systematic equilibrative tendencies. Finally, it presents an alternative vision of the market process that rejects the notion that competitive markets tend to generate improved coordination of economic plans.

2.3.2 Antecedents to the entrepreneurial-discovery approach

The modern Austrian theory of entrepreneurship has its origins in the works of Mises and of Hayek. 'From Mises the modern Austrians learned to see the market as an entrepreneurially driven process. From Hayek they learned to appreciate the role of knowledge and its enhancement through market interaction, for the equilibrative process' (Kirzner 2000: 11; emphasis added). Mises emphasised the dynamic and entrepreneurial character of the market process. He saw the market process as generated by the actions of profit-seeking entrepreneurs who operate in a radically uncertain world:

The driving force of the market process is provided neither by the consumers nor by the owners of the means of production – land, capital goods, and labour – but by the promoting and speculating entrepreneurs. These are people intent upon profiting by taking advantage of differences in prices. Quicker of apprehension and farther-sighted than other men, they look around for sources of profit. ... Profit-seeking speculation is the driving force of the market as it is the driving force of production. (Mises 1966: 328–329)

In his magnum opus, *Human Action*, Mises analyses market processes rather than equilibrium states. Entrepreneurial activity plays a crucial role in the former, but there is no scope left for it in the latter. Nonetheless, the equilibrating properties of the market process depend vitally upon the activities of entrepreneurs. Entrepreneurs see opportunities for profit in the conditions of disequilibrium. Competition among profit-seeking entrepreneurs is the agency which would bring the market prices of all goods and services to their equilibrium levels if no further changes in market data were to take place. Indeed, Mises considers entrepreneurship to be analytically inseparable from the process of competition. In contrast, Hayek did not focus explicitly upon the role of entrepreneurship in explaining the market process. Rather, he emphasised the role of knowledge and mutual learning. He examined how, in the course of the market process, market participants come to obtain more accurate knowledge of each other's plans. Indeed, Hayek (1978) conceived of the competitive market process as a discovery procedure. In his seminal articles, he referred to the competitive process as a procedure for the discovery of particular 'facts' that are useful for achieving specific, transitory purposes.³ Hayek was not so much concerned with major discoveries, such as technological advances, but with rather minor discoveries about individual wants at particular times and places. More specifically, competition

is a spontaneous process that leads to the discovery of previously unsatisfied ‘wishes and desires of the consumers, including the goods and services which they demand and the prices they are willing to pay’ (Hayek 1948: 96). It also leads to the discovery of lower-cost techniques for producing existing commodities and new methods of industrial organisation. Moreover, these discoveries are localised so that different people have access to different information. This point brings us to a pivotal idea in Hayek’s thought – the so-called ‘knowledge problem’. This problem consists in the dispersed character of available knowledge in a society:

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate ‘given’ resources – if ‘given’ is taken to mean given to a single mind which deliberately solves the problem set by these ‘data’. It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality. (Hayek 1948: 77–78; emphasis added)

Hayek highlighted the central role of the price mechanism in mobilising local knowledge of resources, technology and preferences. Each individual possesses unique and often tacit knowledge of the particular circumstances of time and place. It is only by utilising such knowledge in conjunction with the price mechanism that rational economic decisions are able to be made. ‘The most significant fact about this [price] system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action’ (Hayek 1948: 86). Only a competitive market system with decentralised decisionmaking is capable of addressing (if not dissolving) the Hayekian knowledge problem. Building upon Mises’ work, Hayek developed the implications of these insights into a devastating critique of socialism. In particular, he argued that the knowledge problem implies the impossibility of rational economic calculation under central planning. The reason is that, in the absence of a price mechanism, the socialist planner is unable to access the economic knowledge necessary to coordinate economic activity (see Lavoie 1985a). Both Mises and Hayek were

instrumental in creating a distinct modern market-process approach that is separate from mainstream neoclassical economics. Although there are differences between Mises' and Hayek's conceptions of the market process, their two perspectives are highly complementary and mutually reinforcing:

It is true that Mises did not draw special attention to the mutual learning that must occur during the entrepreneurially-driven process of equilibration. Nor did Hayek emphasise the speculative, entrepreneurial character of the market process. But ... these two ways of articulating a theory of market process turn out to be two sides of the same coin. (Kirzner 1997b: 18)

Kirzner's theory of entrepreneurial discovery is based upon the complementarity between Mises' and Hayek's insights into the market process.

2.3 Kirzner's theory of entrepreneurial discovery

In common with much of mainstream economics, Hayek's analysis suffers from one serious problem: it assumes that all market participants are pricetakers. The question remains: how are prices (and other elements of the marketing mix) determined and how do they move towards their equilibrium levels? Kirzner bridges the theoretical deficit left by Hayek by providing a theory of entrepreneurial price adjustment that develops the work of Mises. In Kirzner's theory, the price-adjuster is the entrepreneur. Entrepreneurs perceive changes in economic circumstances, discover imperfect coordination between individual decisions and adjust prices to new market conditions.

Kirzner's perspective on entrepreneurship thus seeks to explain the process of economic coordination in modern market economies.

Kirzner's single-period model of entrepreneurial alertness

In Kirzner's original and simplest formulation of his theory (1973; 1979), entrepreneurship is defined exclusively in terms of a market for a single good within a single period. Kirzner appropriately describes this theory of entrepreneurship as an arbitrage theory (in fact Kirzner never distinguishes between arbitrage and entrepreneurship). The entrepreneur in a single-period market is an arbitrager who discovers inconsistency between transactions in different parts of today's market. The inconsistency manifests itself in a multiplicity of prices for the same good.

Market participants who sold for low prices did not coordinate their plans with those who have bought for higher prices. The entrepreneur discovers existing interlocal price differences for the same commodity in the same market (i.e. where buyers have been paying too much and where sellers have been receiving too little). The price discrepancy represents an opportunity for pure entrepreneurial profit. The entrepreneur knows exactly what to do: the entrepreneur bridges the gap by offering to buy for a little more and to sell for a little less. ‘The pure entrepreneurial function consists in buying cheap and selling dear – that is, in the discovery that the market has undervalued something so that its true market value has up to now not been generally realised’ (Kirzner 1997b: 34). The price movements arising from entrepreneurial actions gradually communicate increasingly accurate information to more and more market participants. The actions of pioneering entrepreneurs confront less alert entrepreneurs and imitators with information that they themselves were not sufficiently alert to discover. Thus, the process of capturing entrepreneurial profits is at the same time a process of correcting market ignorance. Entrepreneurial alertness not only drives the prices of a given commodity towards equality throughout the market, however. It also continually redirects resources from lower-valued uses (as indicated by the prices consumers are willing to pay) to higher-valued uses. It thereby accounts for the market forces responsible for the allocative efficiency of market economies: ‘It is the law of a single price which, working through the process of entrepreneurial discovery, powerfully redirects the pattern of capitalist production into more, rather than less, allocatively efficient channels’ (Kirzner 1997b: 43).⁵ Kirzner extends this simple analysis to include arbitrage opportunities arising from imperfect coordination between transactions in resource markets and those in product markets. The imperfect coordination expresses itself in a divergence between the price of inputs in factor markets and the price of outputs in product markets. More precisely, the divergence represents the difference between the sum of prices in factor markets of a bundle of resources required to make a product and the price of that commodity in the product market. This discrepancy in prices is generated by pure error on the part of market participants: ‘some market participants have undervalued these resources relative to the future eagerness of consumers to acquire the product in question when it can be produced’ (Kirzner 1997b: 41). Thus, entrepreneurship includes alertness to price differences in factor and product markets for what is essentially the same good.⁶ Indeed, one of the most ‘crucial junctures’ where entrepreneurial alertness is likely to be required is the interface between the

factor market and the product market because many of the unnoticed opportunities comprise possibilities for improved coordination between transactions in factor markets and product markets (Kirzner 1973: 44). This then can also be expected to be the major locus of entrepreneurial activity. The entrepreneur can thus be conceived as a type of linking pin or middle person connecting external factor and product markets: ‘The essence of entrepreneurial activity ... involves simultaneous participation in more than one “market” – in fact, this activity consists of linking up different markets’ (Kirzner 1973: 124). Indeed, regulatory reform of markets for key inputs (such as finance, energy, transport, telecommunications and labour) can give a spur to entrepreneurial activity between factor and product markets.

Kirzner’s multi-period model

The single-period arbitrage theory is limited to the more or less instantaneous discovery and exploitation of interlocal price differences. In the generalisation of this theory, Kirzner uses single-period alertness as an analogy for speculative entrepreneurship in a multi-period context: that is, for a theory of the discovery and exploitation of intertemporal (rather than interlocal) price differences in the same commodity market or between factor and product markets. It is assumed that alertness to imperfect coordination between different parts of today’s market is the same as recognising imperfect coordination between transactions today and transactions in the next period’s market. In short, the coordination of markets across space (i.e. arbitrage) is regarded as essentially the same as the coordination of markets across time (i.e. speculation). Furthermore, the overall function of entrepreneurship in a multi-period context is argued not to change from that in the single-period case:

It is still the case ... that the entrepreneurial function is that of bringing about a tendency for transactions in different parts of the market (conceived broadly now as including transactions entered into at different times) to be made in greater mutual consistency. (Kirzner 1982c: 154)

In the single-period case, the entrepreneur equilibrates the present market by promoting convergence towards a uniform market price. Correspondingly, in the multi-period case, the entrepreneur coordinates present transactions with future transactions. Kirzner also extends the arbitrage analogy to include the introduction of new productive processes, new products and new forms of organisation.

Ignorance as the source of entrepreneurial opportunities As mentioned above, according to Kirzner's theory, scope for entrepreneurial activity is provided by imperfect coordination between transactions in different parts of the market. The imperfect coordination in turn arises from ignorance. (In a situation of perfect knowledge and no ignorance, one would expect the law of one price to prevail.) Indeed, the particular type of ignorance that Kirzner argues is important for providing scope for entrepreneurial alertness is the inexplicable 'failure to utilise a resource available and ready to hand', the failure of market participants to perceive opportunities 'staring them in the face' (Kirzner 1979: 130). The term 'ignorance' means that market participants are unaware of and overlook superior opportunities available to them. This ignorance takes the form of over-pessimism, and Kirzner refers to the mistakes to which it gives rise as errors of over-pessimism. Over-pessimism arises from underestimating the willingness of sellers or buyers to trade in a commodity. Buyers pay 'too high' a price for a good because they are simply unaware that potential sellers exist who would sell to them at more favourable terms. Sellers accept 'too low' a price because they are unaware that potential buyers exist who would buy from them at higher prices. Opportunities for mutually beneficial exchange between buyers and sellers are not noticed and fail to be exploited. 'We notice immediately that where the conditions for exchange in fact exist but are not exploited owing to ignorance there now exists scope for profitable entrepreneurship' (Kirzner 1973: 216). According to Kirzner, knowledge of a profit opportunity simply involves entrepreneurs opening their eyes and discovering economic facts that had previously been overlooked by all other market participants. The entrepreneur simply perceives an exogenous change that has already taken place in consumer tastes, technological knowledge or resource availability. It should be noted that imperfect coordination between decisions (i.e. market disequilibrium) and the resultant opportunities for entrepreneurship cannot be wholly explained in terms of high positive transaction and information costs. For even in a market with zero transaction costs, mutually beneficial exchanges might still fail to take place (and hence scope for entrepreneurial alertness may still arise). The implication is that public policies to reduce transaction costs may not necessarily increase entrepreneurial activity. If the members of a society are not alert, profitable exchanges will fail to occur even under ideal conditions of zero transaction costs.

A final point is that there is another type of ignorance that takes the form of over-optimism. Excessive optimism arises from believing that buyers and sellers are more eager than they really

are, as, for example, when potential buyers mistakenly expect to purchase a good at a price so low that it is not available at that price, or when sellers plan to sell a good at a price so high that no buyer is willing to pay that price. These errors generate a disequilibrium price for a commodity that is either too low or too high to clear the market. Errors of over-optimism are likely to be discovered faster than those stemming from over-pessimism, because over-optimistic errors lead to a distinct disappointment of market participants' plans (which is observed directly in the form of shortages and surpluses) and they tend to require less intense alertness for their correction. 'Such disappointment can be expected to alert entrepreneurs to the true temper of the market' (Kirzner 1997b: 45). When shortages exist, entrepreneurs nudge prices higher and expand supply through production or arbitrage. When surpluses exist, they nudge prices lower.

2.3.3 Characteristics of entrepreneurial alertness

Boldness, impulse, hunch are the raw materials of entrepreneurial success (and failure). (Kirzner 1997b: 39)

It is important to examine the unique characteristics of entrepreneurial alertness if we are to appreciate this elusive concept and to understand the types of institutions and economic policies that are likely to be conducive to it. A general point is that entrepreneurship is not a factor of production, not even a special kind of productive factor (Kirzner 1979: 180–181). The characteristics of entrepreneurial alertness which distinguish it sharply from conventional economic resources can be summarised as follows:

1. Entrepreneurial alertness does not represent the mere possession of superior knowledge of market opportunities;
2. Entrepreneurial alertness is non-deployable and tacit;
3. No market exists for hiring entrepreneurial services, and entrepreneurship cannot be treated in terms of demand and supply curves;
4. Entrepreneurship is costless.

Entrepreneurial alertness does not represent the mere possession of superior knowledge

Entrepreneurial alertness is 'the knowledge of where to obtain information (or other resources) and how to deploy it' (Kirzner 1979: 8). Entrepreneurial alertness is a kind of prior knowledge or

foreknowledge. In this connection Kirzner is echoing the distinction between two types of knowledge recognised by Samuel Johnson: 'Knowledge is of two kinds. We know a subject ourselves, or we know where we can find information about it.' Entrepreneurial alertness refers to the latter kind of knowledge. More specifically, entrepreneurial alertness is defined as the knowledge of where to find market data rather than the knowledge of substantive market information per se. An important implication of this definition is that alertness does not represent the possession of superior knowledge concerning market opportunities. The entrepreneur is not necessarily privy to specific or localised information that other agents do not possess. 'What the entrepreneur possesses rather is a sense for discovering what is around the corner' (Kirzner 1984b: 3). Alertness does not involve simply knowing more than others do where inputs can be purchased most cheaply or where outputs can be sold at the highest prices. Hence, entrepreneurship is alertness to the opportunities presented by new and existing information rather than the possession of information by itself. This distinction may be clarified by considering the example of an entrepreneur who hires a marketing manager. It is granted that the marketing manager may possess superior knowledge concerning market conditions – for example, by having specific or localised information on changes in the marketing environment, including changes in the problems faced by particular market segments. However, since the manager cannot see how his or her knowledge can be successfully employed (if the manager had done, he or she would have acted as his or her own employer), it is the entrepreneur who exhibits the higher level of alertness in perceiving the opportunity presented by the information possessed by the manager. The alertness of the entrepreneur is the abstract, very general and rarefied kind of knowledge which we must ultimately credit with discovering and exploiting the opportunities specifically unearthed by those whom [the entrepreneur] has been wise enough to hire, directly and indirectly' (Kirzner 1973: 69). If entrepreneurship were conceivable in terms of superior knowledge, there would exist a factor market in which the services of people who possess such entrepreneurial knowledge could be hired. However, no such market exists (see below). Hence, public policy proposals to increase the supply of market information and technical information (e.g. trade commissioner services, information bureaux and statistical data) cannot be considered to increase entrepreneurship directly. Entrepreneurial alertness is still required to perceive any profit opportunities that may be presented by such information. Entrepreneurship can also be argued to be pushed back to an earlier stage: the stage at which public policy-makers decide on

where to find relevant information and when they choose the information they consider worth collecting in the first place. The completion of any possible mutually beneficial transactions that are suggested by publicly provided or publicly funded information is by no means inevitable, and it is very definitely not automatic or instantaneous. People may still not be aware of that information, even if the government were to make it available at zero cost; they must still perceive the opportunity to learn that information (Kirzner 1973: 227).

Entrepreneurial alertness is non-deployable and tacit

It is argued that entrepreneurial alertness differs fundamentally from conventional economic resources, such as technical knowledge, in that, unlike technical knowledge, it is not possible to make deliberate decisions concerning the deployment of entrepreneurial alertness. The entrepreneur is not able to decide whether or not to deploy it, for which competing purposes to deploy it, and how and in what quantity to deploy it (Kirzner 1983b: 64). In the course of their decision-making, entrepreneurs do not consider their hunches as a means (i.e. a stock of knowledge) available to achieve given ends. Individual entrepreneurs cannot decide to allocate, say, 10 per cent of their alertness to the discovery of opportunity A, and the remaining 90 per cent to the discovery of opportunity B. Entrepreneurial alertness is not a resource that can be acquired deliberately like other aspects of human capital. A major factor which gives rise to the non-deployability of entrepreneurship is its tacit nature. An essential difference between entrepreneurial and technical knowledge is that the entrepreneur lacks self-consciousness concerning the former. Rather than being aware of their hunches, entrepreneurs' actions simply reflect their hunches. A further aspect of this tacit quality is that entrepreneurs are not able to articulate or explain their alertness. Kirzner's conception of entrepreneurship as non-deployable and tacit stands in stark contrast to that in neoclassical treatments of entrepreneurial supply, such as Baumol (1990), Casson (1982), Murphy et al. (1991) and Schultz (1975). They rely on the idea of entrepreneurship as a resource that can be allocated like any other factor of production. They contend that the institutional context and the rules of the game (the reward structure of the economy) affect the allocation of entrepreneurial resources between productivity-increasing activities, such as innovation, and largely unproductive, redistributive activities, such as rent seeking and organised crime.

No market exists for hiring entrepreneurial services

The implication of the previous arguments is that no market exists for the hire of entrepreneurial services because the market and the entrepreneur are unaware of the need for (or the existence of) entrepreneurial alertness for any particular opportunity (Kirzner 1979: 174). Furthermore, the market does not recognise that any particular individuals possess entrepreneurial alertness. It does not identify any specific ability for discovering price discrepancies or profit opportunities, even though individuals differ in their ability to perceive entrepreneurial opportunities. Were the market to recognise entrepreneurial alertness in the sense of an available useful resource, there would be 'markets in which this factor service was hired, with its price rising to reflect its full productivity, ruling out scope for pure market profit' (Kirzner 1979: 181). Consequently, strictly speaking, it is not possible to treat entrepreneurship in terms of demand and supply curves. The market does not demand (in the ordinary sense) the services of entrepreneurs. For any instance of imperfect plan coordination about which market participants are supposed to be ignorant, it is not possible for these same market participants then to demand a service that is supposed to discover that very maladjustment. It should be noted that to hire 'an entrepreneur' is to be an entrepreneur. (On the other hand, if they are aware of a particular opportunity, then they do not need to hire alert entrepreneurs to discover it.) Market entrepreneurship reveals to market participants imperfect coordination and opportunities that they did not realise existed and that they did not recognise as needing correction. The implication for public policy-makers is that identifying entrepreneurs ex ante is very problematic. Furthermore, if public policymakers subjectively believe that they can discover opportunities to improve the existing structure of the economy, then they are also trying to act as entrepreneurs by spotting possibilities for better coordination.

Entrepreneurship is costless

An essential characteristic of entrepreneurial knowledge is that it is spontaneously learnt, spontaneous in the sense that it is acquired entirely without being planned. Entrepreneurial alertness is the ability to discover unexploited profit opportunities without deliberate search for information:

What distinguishes discovery (relevant to hitherto unknown profit opportunities) from successful search (relevant to the deliberate production of information which one knew one had lacked) is

that the former (unlike the latter) involves that surprise which accompanies the realization that one had overlooked something in fact readily available. ('It was under my very nose!') (Kirzner 2000: 18; emphasis added)

When entrepreneurs make surprising discoveries, their discoveries are not the result of any prior deliberate search for a missing piece of information –they do not know beforehand how much information they lack, the value of the missing information or the cost of obtaining it. Alertness may, however, include the discovery of previously unrecognised opportunities for deliberate search (e.g. market research), but this initial discovery is itself not the product of deliberate search activity by the entrepreneur. (For further discussion on the differences between deliberate search and entrepreneurial alertness, see Reekie 1984: 93–100.) The cost of using technical knowledge is measured in terms of opportunity cost: the cost of using technical knowledge for a particular purpose is the value of the best forgone alternative. In contrast, entrepreneurial alertness does not involve opportunity costs because hunches are learnt spontaneously. No resource inputs are involved in acquiring them since no deliberate act of learning or of search is undertaken. However, in describing entrepreneurial knowledge as costless, Kirzner provides clarification to avoid potential misunderstanding: 'To be sure, the spontaneous learner has incurred no cost or sacrifice through his learning. But this is not so much because the knowledge was costlessly available as because the knowledge was simply not deliberately sought' (Kirzner 1979: 143). Klein (1999) develops a similar line of thought. He writes that, rather than regard the cost of an entrepreneurial hunch as zero, it is better to regard the concept of cost as not applicable to pure entrepreneurship (at least not to the 'deep level of mind' where Klein argues entrepreneurial 'epiphanies' occur). Opportunity cost relates to choice, and in Kirzner's eyes, entrepreneurial discovery is not an object of choice. 'Kirznerian entrepreneurship is costless in the sense that sound is weightless – not that sound weighs zero pounds, but that the concept of weight does not apply to sound' (Klein 1999: 54).

Demsetz (1983) does not agree that entrepreneurship is costless (though he does concede that in many cases the costs of alertness might not be significantly different from zero). First, Demsetz regards the time and mental energy that an entrepreneur devotes to considering a prospect and judging its potential as a cost of maintaining alertness, because the entrepreneur's mind is diverted from other tasks. Second, costly prior acquisition of knowledge may be necessary in

order to discover opportunities. This latter viewpoint appears to be supported by a recent empirical study. In the first phase of a three-part investigation, Shane (2000) undertook an in-depth field study of eight sets of entrepreneurs who exploited a single MIT invention (a three-dimensional printing process). The range of ventures included ceramic casting, drug manufacture, the manufacture of ceramic filters and orthopaedic applications. He tested hypotheses to do with whether entrepreneurs discover those opportunities that are related to the information that they already possess. In particular, he examined the effects of entrepreneurs' prior knowledge of markets, of ways to serve markets, and of customer problems, on the process of entrepreneurial discovery. His The theory of entrepreneurial discovery results showed not only that prior knowledge influences the discovery of opportunity,⁸ but also that much of the prior knowledge is developed through costly and idiosyncratic education, research and work experiences. For example, in one venture to manufacture ceramic filters for the power generation market, the education and work experience in ceramic engineering of the entrepreneurial team enabled them to see how the MIT invention would solve problems with filter geometry and could make uniform-porosity ceramics. The results of Shane's field study do, however, indicate that the entrepreneurial-discovery process is one of recognition rather than a search for information. None of the eight entrepreneurs believed that their respective opportunity was obvious from information about the MIT invention alone. Nor did any of the entrepreneurs believe that they were searching for the opportunity prior to its discovery.

As one entrepreneur in the study put it: 'For whatever reason ... I just intuitively saw the opportunity in chronopharmacology. I certainly wasn't searching for the opportunity.' It should also be noted that not all theorists who emphasise superior perception as the defining characteristic of entrepreneurship are in agreement with Kirzner's exclusion of search activity from the entrepreneurial function. In contrast to Kirzner, for instance, Casson (1982) includes the search for information within the entrepreneurial function and emphasises that entrepreneurial search does not just involve the extensive collection of facts. A synthesis of information is also required in identifying opportunities for coordination. Furthermore, Casson regards the judgemental decisionmaking of the entrepreneur as having a positive opportunity cost.

2.3.4 Kirzner's conception of the market process

Up to now, we have talked about the market process in very general terms. It is now timely to define precisely what Kirzner means by 'market process' and to examine the properties of this phenomenon. I finish this section by considering criticisms of Kirzner's version of the market process.

Defining the market process

The Meaning of Market Process, sets out to clarify the most important aspects of his conception of the market process. His analysis distinguishes between two sets of variables. On the one hand, we have underlying variables (UVs), which by convention are defined as consumer preferences, population, resource availabilities and technological possibilities. To this list of UVs within Kirzner's model, I would also add institutions, legal rules and property rights. On the other hand, we have induced variables (IVs), which include prices, production processes, output quantities and qualities. These are the variables that market participants set and adjust under the effects of the UVs.

Changes in these two types of variables comprise two distinct sets of forces for economic change. Changes in UVs are exogenous and disequilibrating; changes in IVs are endogenous and equilibrative. The latter are endogenous in that market forces systematically generate them. In mainstream microeconomics, changes in UVs are at all times fully and instantaneously reflected in observed changes in IVs. 'Equilibrium economics postulates that at each and every instant the actual market values of the IVs are those equilibrium values predetermined by the relevant values of the UVs' (Kirzner 1992: 42). In contrast, by emphasising the role of knowledge and learning in processes of equilibration, Kirzner sees the impact on IVs of changing UVs as far less mechanical and deterministic: 'The former retain a degree of freedom with respect to the latter' (Kirzner 1992: 42). However, movements of IVs in the market are not completely divorced from changes in underlying market data. Thus, the sequence of values of IVs is neither fully determined by, nor entirely independent of, the values of UVs. Kirzner's theory defines the market process exclusively in terms of the second set of changes – changes in IVs. More specifically, the market process refers to the endogenous changes in IVs that occur as entrepreneurs discover price differentials and exploit opportunities for pure profit inherent in

disequilibrium market conditions. 'The market process, then, consists of those changes that express the sequence of discoveries that follow the initial ignorance that constituted the disequilibrium state' (Kirzner 1992: 44). In its purest analytical form, the market process comprises that sequence of changing IV values that would occur even if we were to isolate IVs artificially from the effects of exogenous changes in underlying data. If such changes in UVs could be suspended, the market process would continue until all gaps in awareness (of what other participants are planning to do) were eventually filled.

In Kirzner's view, the market possesses a systematic tendency towards the diffusion of knowledge and equilibrium: 'The entrepreneurial process ... is a process tending toward better mutual awareness among market participants. ... Enhanced mutual awareness, via the entrepreneurial discovery process, is the source of the market's equilibrative properties' (Kirzner 2000: 19). That a strong tendency towards enhanced mutual knowledge and equilibrium exists in all markets at each moment, implies that individuals are tending to revise their plans in a manner that makes them more coordinated over time (O'Driscoll 1978: 129). The significance of this systematic equilibrating tendency is that it accounts for the degree of allocative efficiency and growth potential of market economies. Although acknowledging the possibility for entrepreneurial discoveries to be mistaken and disequilibrating, Kirzner nevertheless maintains that there is a systematic tendency for entrepreneurs in general to make genuinely corrective discoveries rather than spurious error-enhancing ones. Moreover, there is a tendency for earlier entrepreneurial errors (which themselves create profit opportunities) to be replaced by profit-making entrepreneurial corrections. 'The market process view sees the market as displaying, at all times, the effects of powerful forces encouraging genuine and valuable discovery' (Kirzner 1992: 46). But the existence of a systematic equilibrating tendency does not imply that this tendency actually proceeds to full completion. In the real world, market processes never succeed in achieving equilibrium because they are continually interrupted by new exogenous developments in consumer preferences, resource availabilities and technical possibilities (i.e. changes in UVs). These changes in turn set in motion new market processes which may collide with, interrupt or reinforce other market processes initiated at different points in time:

The market process that we have outlined offers a systematic tendency, rather than a sure-fire machine-like trajectory. Moreover, the assurance that we feel concerning the overall tendency of

the market process is clearly dependent upon the rate at which unanticipated changes in UVs impinge on the market. Were these changes to be so drastic in their volatility and rate of occurrence as to swamp the discovery potential inherent in entrepreneurial alertness, we could hardly expect the market process to manifest itself, in the real world, in a manner able to generate order in the face of apparent chaos. The market agitation thus generated by chaotic change in UVs could thus fail to display the underlying tendencies towards orderliness which entrepreneurial processes under less extreme conditions set into motion. (Kirzner 1992: 51)

Kirzner (1992: 35) acknowledges that such circumstances are not just a theoretical possibility. There may well be instances in capitalist history where the ‘power of the coordinative market process’ has been overwhelmed by the volatility of change in underlying market data and by the high rate of entrepreneurial errors. Thus, such considerations may be especially important in the context of economic development and transition. During radical structural changes and rapid processes of liberalisation and transition, changes in UVs may be so extremely volatile, frequent and unpredictable that entrepreneurial activity does not generate greater social coordination (i.e. better mutual awareness and better consistency of plans). If political institutions, legal rules and property rights, for instance, are changing rapidly and erratically, the strength of disequilibrating forces might well overwhelm equilibrating forces so that market activity exhibits little tendency towards order. However, other things being equal, the more freedom entrepreneurs have in such circumstances to respond to perceived disequilibria and changes in underlying variables, the greater the likelihood that the market process will be able to engender some degree of orderliness. Conversely, the greater the institutional constraints on entrepreneurial adjustment in such a situation, the more severe and prolonged the instability and disorder that is likely to ensue.

An alternative vision of the market process

Kirzner’s assertion that, in the absence of extreme conditions, the market possesses a systematic equilibrative tendency is not without its critics. In particular, Lachmann (1986) and his followers have emphasised the radical uncertainty inherent in human action and its implications for the possibility of equilibration and coordination. According to this view, at each instant under even normal economic conditions, there is no assurance that equilibrative forces outweigh disequilibrating forces, with the result that we can never be sure that the market process, on balance, tends towards equilibrium. In Lachmann’s system, there is apparently no systematic

tendency towards improved coordination (in the conventional sense of ex ante consistency among participants' plans). Indeed, the entrepreneurial character of the market process itself engenders some discoordination of existing patterns:

In a competitive game there are winners and losers. By the same token, competitive market forces will cause discoordination as well as coordination of agents' plans. In fact they cannot do the latter without doing the former. No agent can enter a market, or extend his range of activity within one by making offers to other agents, without disrupting some market relationship presently existing between them and others. This fact is of course of the very essence of competition. (Lachmann 1986: 5; emphasis added)

Lachmann (1976) uses Shackle's (1972) notion of a 'kaleidic society' to emphasise that we cannot even speak of the market process as tending to generate greater mutual awareness among market participants. Unlike Kirzner's model, there is no reason to expect that entrepreneurs in Lachmann's system will tend to proceed in the right direction to correct previous errors.¹⁰ Indeed, the inevitability of continual disequilibrating changes makes it impossible for entrepreneurs to make the right decisions and to determine what adjustment in prices and output is necessary to bring about movement towards equilibrium. 'Nobody can take his equilibrium bearings if he does not know how others will act. ... The beacon that had been designed to keep entrepreneurs from straying from the narrow path of convergent expectations turns out, on most nights, to be rather dim' (Lachmann 1994: 204–205).

Following Lachmann, many market-process economists recognise the significance of disequilibrating tendencies in markets. They regard entrepreneurial error and disequilibrium as an inevitable and essential element of the market process. Endogenous adjustment in IVs is thus both an equilibrating and a disequilibrating force:

These disequilibrating tendencies are not simply the result of changes in the exogenous data but emanate from the source of equilibrating behavior, that is, the indeterminate or creative response to perceived profit opportunities. 'The same active mental processes which are taken to adjust to change once it has occurred, will also originate change' (High, 1986, p. 115). The very process of adjustment – or rather attempted adjustment – will produce errors that undermine equilibration. If this were not the case and if only systematic equilibrating tendencies existed,

then money and, more generally, market institutions would tend to disappear. (Rizzo 1996: xvii–xviii; emphasis added)

That concludes the summary of Kirzner’s theory of entrepreneurial discovery and its implications for the market process. As an exercise in pure economic theory, Kirzner avoids delving into the psychological context of the entrepreneurial function. The task of the next chapter is to apply his theory in conjunction with other approaches in order to examine the psychological determinants of entrepreneurship and, in particular, the cognitive underpinnings of the economic construct of entrepreneurial alertness. In subsequent chapters, Kirzner’s approach serves as a highly effective analytical tool for understanding the impact of institutions and culture on entrepreneurship.

2.4. Entrepreneurship Theory for Regional Development

2.4.1 Entrepreneurship and Economic Growth

Economies grow through some combination of greater inputs – more educated labor and additional capital – and through advances in technology. Whether it is home grown or imported from abroad, technological advances are useful from an economic point of view only when they are commercialized, applied to make new products, make existing produces more efficiently, or deliver new services.

Both established and new firms commercialize these advances, but the historical record makes clear that new firms, without a vested interest in the status quo, are disproportionately responsible for disruptive or radical innovations while established firms tend to focus more on incremental advances. Examples of incremental advances in United States include the telegraph, the telephone, the computer, the car, the airplane, much computer software, air conditioning, and interne search, to make some of the most obvious. This list also, not coincidentally, includes technologies that define modern life and power advances in growth and living standards.

Entrepreneurs are also crucial in developing countries, where they either may be copying and importing advanced country ideas, or developing and commercializing their own “bottom of the pyramid” products and services tailored for the income levels of their countries.

2.4.2 Entrepreneurial Economies provide opportunities

Entrepreneurial economies are those driven by individuals who choose entrepreneurship rather than accept a second-class career because they can't find a job. There is an element of culture that is difficult to pin down, but in entrepreneurial economies, striking out on one's own is as not only an acceptable career path, but a desirable one, not only for the control it gives to those who seek it but for the rich rewards it gives to the most successful.

Entrepreneurial capitalism is the most effective driver of economic growth because it provides opportunities for new firms to innovate and create new markets. The advantage of new firms is their independence. Because founders of companies do not often have a vested interest in the status quo, they are more likely to commercialize the disruptive innovation that is responsible for the lion's share of long-run growth.

Other types of capitalism have different effects. Oligarchic capitalism, where resources and power in the economy are concentrated in the hands of a few, tends not to maximize economic growth but to maximize the welfare of the powerful. State guided capitalist systems, which channel resources to industries deemed most likely to be successful, can lead to rapid early growth, but are likely to stall as they approach the technological frontier. Big firm capitalist systems benefit from economies of the scale, resources for research and development, and capital to deploy, yet big firms hesitate to invest in new products or services that can make their current profit centers obsolete. We must be careful to properly align incentives in capitalist system in a way that encourages entrepreneurial solutions.

2.4.3 Creativity, Entrepreneurship and Regional Economic Growth

Economists and Geographers have always accepted that economic growth is regional, that it is driven by and spreading from specific regions to, cities, or even neighborhoods. Many research, long ago pointed to the role of places as incubators of creativity, innovation, and new firms and industries. The earliest explanation of this phenomenon was that places grow either because they are located on transportation routes or because they have endowments of natural resources that encourage firms to locate there. According to this conventional view, the economic importance of a place is tied to the efficiency with which one can make things and do business. Governments

can employ this theory when they use tax breaks and highway construction to attract business. But these cost related factors are no longer key to success.

Another major theory to regional growth suggests that place remains important as a locus of economic activity because of the tendency of firms to cluster together. This view builds on the seminal insights of the economist Alfred Marshall. The contemporary variant of this view, advanced by Mikael Porter, has many proponents in academia in the practice of economic development. It is clear that similar firms tend to cluster.

The question is not whether firms cluster but why. Several answers can be offered.

- Some experts believe, as Marshall did, that “agglomerations” of similar firms capture efficiencies generated from tight linkages between the firms.
- Others say it has to do with the positive benefits of co-location, which are sometimes referred to as “spillovers”. Still others claim agglomeration occurs because certain kinds of activity require face to face contact. But these are only partial answers.

Over the past decade or so, a more powerful theory to explain city and regional growth has emerged. The basic idea behind this theory is that people are the motor for growth. Its proponents thus refer to it as the “human capital” theory of regional development. The proponents of human capital theory argue that the key to regional growth lies not in reducing the costs of doing business or in the clustering of firms, but in enhancing regional endowments of highly educated and productive people.

The human capital theory owes a particular debt to the work of Jane Jacobs. Decades ago, Jacobs noted the ability of cities to attract creative people and thus spur economic growth. For a long time academic economists ignored her ideas, but in the past decade or two they have been taken up with gusto.

Cities would be economically infeasible if not for the productivity effect associated with endowments of human capital: If we postulate only the usual list of economic forces, cities should fly apart. The theory of production contains nothing to hold a city together. A city is simply a collection of factors of production – capital, people and land – and land is always far cheaper outside cities than inside ... It seems to me that the ‘force’ we need to postulate to

account for the central role of cities in economic life is of exactly the same character as the ‘external human capital’.

Studies of national growth find a clear connection between the economic success of nations and their human capital, as measured by the level of education. This connection has also been found in regional studies that human capital is the central factor in regional growth.

According to Glaeser, such clustering of human capital is the ultimate source of regional agglomerations of firms. Firms concentrate to reap the advantages of that stem from common labor pools and not to tap the advantages from linked networks of customers and suppliers. Research shows that, a good deal of city growth over the twentieth century can be traced to cities’ levels of human capital at the beginning of the century.

Places with greater numbers of talented people grew faster and were better able to attract more talent. For our purposes, places with high concentrations of human capital both attract existing firms and provide the habitat required to create new entrepreneurial firm formations.

The human capital theory asserts that economic growth will occur in places that have highly educated people. It begs the question: Why do talented, creative, and entrepreneurial people cluster in certain places? The three basic reasons for these are:

- Thick labor markets: People don’t just want a job; they want a lot of jobs. They know they are going to move around a lot, so they want a “thick labor market”.
- Diversity: People in interviews and focus groups look for visible signs of diversity, such as prevalence of various nationalities and ethnicities as well as visible gay community. These are visual cues that a place is open to all and possesses “low entry barriers” to human capital.
- Quality of place: I define a quality of place in terms of three attributes: what is there – the building, the neighborhoods, the physical design; who is there – the people, the diversity, the human energy; what is going on – the bustling street life, sidewalk cafes, restaurants and music venues, active outdoor recreation.

This shows that regional economic growth is driven by creative people who prefer places that are diverse, tolerant and open to new ideas. This “creative people” theory thus differs from human capital theory in two aspects.

- First, it identifies a type of human capital, creative people that is the key to economic growth.
- Second, it identifies the underlying factors that shape the location decisions of these people, instead of merely saying that regions are blessed with certain endowments of them.

Furthermore, it suggests that creativity is linked to diversity. Diversity increases the odds that a place will attract different types of creative people with different skill sets and ideas. Places with diverse mixes of creative people are more likely to generate new and novel combinations. Diversity and concentration work together to speed the flow of knowledge. Greater and more diverse concentrations of creative capital in turn lead to higher rates of innovation, high technology business formation, job generation, and economic growth. Places that are open to creativity of all sorts (technological and cultural as well as economic) reflect an underlying environment or habitat which favors risk taking and thus will stimulate entrepreneurship and new firm formation.

In more pragmatic terms, my creativity-based theory of regional growth says that technological innovation, new firm formation and regional growth are all related to what the “3 T’s” of economic development: technology, talent and tolerance. To spur innovation, economic growth and other good things a region must have three of them. The 3 T’s explain why regions fail to organize entrepreneurship and to grow despite their deep reservoirs of technology and world class universities: they are unwilling to be sufficiently tolerant and open to attract and retain top creative talent and stimulate risk-taking behavior.

Chapter Three – Characteristics of Entrepreneurship and the Environment of Entrepreneurship

3.1 Characteristics of Entrepreneurship

While there can be as many characteristics of entrepreneurship as there are people in this world with opinions, there are some characteristics that are considered indispensable or necessary in an entrepreneur. These are listed here as follows.

Ability to take Risks

This is the first and foremost trait of entrepreneurship. Starting any business involves a considerable amount of [risk](#) of failure. Therefore, the courage and capacity to take the said risk are essential for an entrepreneur.

Innovation

In a world, where almost everything has been done, innovation is a priceless gift to have. [Innovation](#) basically means generating a new idea with which you can start a business and achieve a substantial amount of profits. Innovation can be in the form of a product, i.e., launching a product that no one is [selling in the market](#). It can also be in the form of process, i.e., doing the same work in a more efficient and economical way.

An easy example of product innovation could be the launching of touch screen cell phones when the world was still using a keypad on cell phones.

Process innovation can be seen in capital-intensive industries that have to replace manual labour with machines, therefore, increasing their production and reducing their costs.

Another type of innovation can be the one concerned with usage. For examples, cell phones are now used for various functions such as viewing, creating and editing various files and documents, thus, eliminating the need for computers to a large extent.

Visionary

Every entrepreneur needs to be a visionary. Without a vision for the future of his [venture](#), he or she would just be working aimlessly without reaching any point of success.

Leadership

An entrepreneur has a vision. However, it takes a lot of resources to turn that vision into reality. One of these resources are the people that the entrepreneur hires to perform various functions like production, supplying, [accounting](#), etc.

A single person cannot perform all the tasks and therefore it is important to bring some more people to do it. This also makes leadership very important as a leader provides the required direction to the efforts of the [employees](#). Without proper [leadership](#), everyone would be working independently without achieving the desired results.

Open Minded

A good entrepreneur realizes that every situation can be a [business opportunity](#). Thus can be utilized for the benefit of the organization. For example, [Paytm](#) realized the significance of [demonetization](#) and recognized that the need for [online transactions](#) was more than ever during this time and so it utilized and grew massively during this period.

Confident and Well Informed

An entrepreneur needs to be confident about his ideas and skills. This confidence also inspires the confidence of the people working for him as well as the other [stakeholders](#) involved in his business.

This confidence comes from being well informed about the industry and environment. Various legal and political [policies](#) enhance business and [trade](#) opportunities, while some hinder them. Having knowledge about these can really help an entrepreneur make the right decision at the right time.

3.1.1 Human capital and entrepreneurship

One is that if entrepreneurs have balanced skills sets, then industries, like art (which requires disparate skills including artistic talent and business management), are less likely to be populated by entrepreneurs than insurance, for example, where the required skill set is more homogeneous. Second, if technological progress demands additional skills requirements, then this is bound to decrease the number of suitably equipped individuals and therefore also the equilibrium number of entrepreneurs. Of course, it can be objected that technological change might also increase individuals' ability to acquire skills, which would weaken this second prediction. There is growing recognition of the importance of human capital to entrepreneurship. Moskowitz and Vissing-Jorgensen had observed that entrepreneurs

earn similar average returns to those obtained from publicly traded equity, yet with a much riskier profile (reflecting the fact that entrepreneurial risk is not easily diversified). Polkovnichenko pointed out that human capital is not put at risk when one becomes an entrepreneur, because future labour earnings are unaffected by the risk of the current business. Hence the risk of total net worth (which includes the present value of human capital) is much lower than of financial wealth alone.

Parker and van Praag predict that more highly educated entrepreneurs will face lower borrowing constraints, which endows human capital with both a direct and indirect effect on entrepreneurial performance. The direct effect is the “rate of return” to education; the indirect effect is enhanced performance via lower capital constraints that enable more productive capital to be obtained. These authors estimated that the combined rate of return for entrepreneurs exceeds the average rate of return for employees, suggesting that highly educated individuals are well placed to become among the most successful entrepreneurs. To conclude, an increasing number of researchers are now developing theories of entrepreneurship that assign a central role to human capital. We are also seeing an emerging unification of human and financial capital influences in the domain of entrepreneurship. These efforts complement earlier (mainly empirical) work that emphasized the importance of experience, especially industry and business experience, for explaining variations in entrepreneurs’ performance.

3.1.2 Social capital and entrepreneurship

An increasingly widely used construct in empirical models of entrepreneurship is social capital. According to Davidsson and Honig (2003, p. 307), ‘social capital refers to the ability of actors to extract benefits from their social structures, networks and relationships’. Social capital can exist at the country level, for example in the degree of trust in government and other institutions, and at the community level, such as the quality of social networks within the locality. Social networks can involve the extended family, communities and organisational relationships. Abell et al. (2001) argue that social capital confers social legitimacy upon entrepreneurship; reveals information about opportunities, customers, suppliers and competitors; and facilitates access to resources such as cheap labour and capital while providing psychological aid, such as helping entrepreneurs to weather emotional stress and to keep their businesses afloat. In principle, social capital might be used to compensate for limited financial or human capital. Social capital can comprise ‘strong’ or ‘weak’ ties. Strong ties come from closer relationships such as one’s direct family or close friends, who can leverage support and trust needed for resource acquisition (Brüderl and Preisendörfer, 1998). Weak ties are loose relationships with former business contacts, acquaintances

and members of business networks such as trade associations or guilds (Parker, 2008b). A pronounced feature of entrepreneurial networks and start-up teams is homophily, which is the tendency for 'birds of a feather to flock together'. Sociologists argue that an important source of homophily arises from strong ties and dense social networks, which constrain individuals to start ventures with people like themselves. While this can facilitate trust and knowledge sharing, it can also close off sources of diverse information which could benefit the entrepreneur (Kim and Aldrich, 2005). An alternative view is that entrepreneurs are over-optimists who work hard and so prefer to match with other over-optimists. Homophily then arises from free choice as a type of assortative matching outcome (Parker, 2009a). Despite the prevalence of homophilous new venture teams, heterophily apparently endows teams with key organisational and performance advantages. With regard to performance, Eisenhardt and Schoonhoven (1990) observed that semiconductor firms.

3.2 Entrepreneurship and Macroeconomic factors

Entrepreneurship is a complex phenomenon influenced by the interplay of a wide variety of factors.

Some of the important factors are listed below:

3.2.1. Personality Factors:

Personal factors, becoming core competencies of entrepreneurs, include:

- (a) Initiative (does things before being asked for)
- (b) Proactive (identification and utilisation of opportunities)
- (c) Perseverance (working against all odds to overcome obstacles and never complacent with success)
- (d) Problem-solver (conceives new ideas and achieves innovative solutions)
- (e) Persuasion (to customers and financiers for patronisation of his business and develops & maintains relationships)
- (f) Self-confidence (takes and sticks to his decisions)
- (g) Self-critical (learning from his mistakes and experiences of others)
- (h) A Planner (collects information, prepares a plan, and monitors performance)

(i) Risk-taker (the basic quality).

3.2.2. Environmental factors:

These factors relate to the conditions in which an entrepreneur has to work. Environmental factors such as political climate, legal system, economic and social conditions, market situations, etc. contribute significantly towards the growth of entrepreneurship. For example, political stability in a country is absolutely essential for smooth economic activity.

Frequent political protests, bandhs, strikes, etc. hinder economic activity and entrepreneurship. Unfair trade practices, irrational monetary and fiscal policies, etc. are a roadblock to the growth of entrepreneurship. Higher income levels of people, desire for new products and sophisticated technology, need for faster means of transport and communication, etc. are the factors that stimulate entrepreneurship.

Thus, it is a combination of both personal and environmental factors that influence entrepreneurship and brings in desired results for the individual, the organisation and the society.

Chapter Four- Institutions and Entrepreneurship

4.1 Institutions I: Rule of law, property and contract

A free society is fertile and creative in the sense that its freedom generates alertness to possibilities that may be of use to society; a restriction on the freedom of a society numbs such alertness and blinds society to possibilities of social improvement. (Kirzner 1979: 239)

4.1.1 Institutions and alertness

The starting point is to consider how different conceptions of the entrepreneurial function, its locus and character will affect such comparative analyses. The chapter then moves on to examine the ideal of freedom as the preeminent constitutional principle for encouraging entrepreneurship. It considers how the principle of freedom is embodied in the rule of law, rights to property and the concept of contract. It puts forward conjectures on what features of constitutional, legal and regulatory rules would generate strong beliefs in personal competence and internal control and would therefore best promote entrepreneurship. The next chapter investigates other institutions that are conducive to entrepreneurship. It examines the role of money and the impact of political and legal decentralisation on the human propensity to be alert to opportunity.

4.1.2 Rule of law, property and contract

Institutions supply the structures within which people interact with each other. ‘They establish the cooperative and competitive relationships which constitute a society and more specifically an economic order’ (North 1981). Institutions are humanly generated constraints on people’s behaviour, and they thereby exclude exogenously given constraints imposed by natural phenomena. Of course, although institutions are the result of human action, they are not necessarily the product of human design. That is, these constraints on people’s activities need not be deliberately established by some human agency. They can evolve spontaneously (Menger 1996; North 1990). No one need ever have consciously intended to bring these institutions about. Furthermore, institutions can be formal in that they are written down and codified, or they can be informal in the sense that we adhere to them without knowing it and without ever formulating them explicitly. According to North (1981), the institutional framework comprises three classes of institutional rules: constitutional rules, operating rules and normative behavioural codes.

Constitutional rules determine the general character of the political order. They represent the ‘superstructure’ that regulates the ongoing process of making ordinary laws (i.e. operating rules). Operating rules – for example, various statute laws and regulations, specific common law decisions – specify terms of exchange within the framework of the constitutional rules. Normative behavioural rules are codes of moral behaviour that legitimate the constitutional and operating rules. This and the next chapter focus upon constitutional rules and, to a lesser degree, operating rules. The emphasis on constitutional rules in the following discussion is not meant to imply that the term ‘institutions’ should only be applied to constitutional rules. Constitutional rules are the fundamental and general principles that define the underlying structure of people’s rights, including property rights. They specify, allocate and limit the different powers of the state. They also define the general attributes which ordinary (i.e. sub-constitutional) laws and rules must possess in order to be implemented and enforced by government (Hayek 1979). Thus, the general principles of the constitution control the content of lower-order constraints or operating rules generated by the legislature, the judiciary, the executive and the administrative bureaucracy. ‘The idea of a constitution, therefore, involves not only the idea of a hierarchy of authority or power but also that of a hierarchy of rules or laws’ (Hayek 1960). A constitution might also include rules for modifying constitutional rules. As stated at the outset, the aim of this chapter is to investigate ‘the institutional conditions conducive to entrepreneurship’. The choice of this phrase rather than the term ‘institutional prerequisites’ is quite deliberate, the reason being that it is very difficult to identify the necessary and sufficient conditions for entrepreneurship. Certainly, some environments are more supportive than others to the flourishing of entrepreneurial initiative. But it seems that entrepreneurship can emerge in the most hostile of climates. ‘Markets are like weeds, they spring up all over and are impossible to stamp out completely. Wherever there is a gap, alert economic actors will attempt to grasp the opportunity available for personal gain’ (Boettke 1993).

In the former Soviet Union, for example, entrepreneurs (in the guise of special intermediaries called *tolkachi*) sprung up within the interstices of the official planned economy, buying and selling commodities on behalf of state enterprises and thereby coordinating production and exchange activity within the overall plan itself (Grossman 1981; Hewett 1988). In addition, we must even take care to define more precisely what we mean by conditions conducive to entrepreneurship. In particular, we must distinguish between demand-side and supply-side

conditions. The former relate to the structure of economic circumstances and incentives in the market environment that gives rise to entrepreneurial opportunities (e.g. market ignorance and resulting price discrepancies). In contrast, supply-side conditions relate to the factors which promote or constrain the generation and application of entrepreneurial alertness.

These two sets of conditions, though interrelated, are not the same. For instance, it is conceivable that in a stationary market environment in which there is no change (i.e. no exogenous disturbances, no disappointment of people's plans over time), there are no entrepreneurial opportunities, even though the individuals in that society are potentially entrepreneurial and would be alert to opportunities if only they existed. On the other hand, it is possible that people's plans to buy and sell could be massively discordant – so that there is an abundance of entrepreneurial opportunities – but these opportunities go unnoticed because people do not have the wit to recognise that they exist, with the result that there is no entrepreneurial activity. Both of these scenarios lead to no entrepreneurship, but the reasons for this inactivity are quite different.

The implications of the function, character and unit of alertness

A further difficulty that arises in connection with examining institutional conditions for entrepreneurship is that certain institutional arrangements may favour one type of entrepreneurship over another. For example, one set of institutional conditions may foster arbitrage but discourage long-term innovation. In such situations, it may be difficult to say whether, on balance, that particular institutional framework is or is not conducive to entrepreneurship. It should be noted that this position differs from Kirzner's (1985: 68–69). Kirzner says that what is conducive for low-level entrepreneurship will also be conducive for high-level entrepreneurship, what fosters short-run arbitrage will also promote long-run innovation. The hypothesis is that numerous incremental acts of entrepreneurship – entrepreneurial discoveries of local and mundane bits of unorganised knowledge – constitute a foundation for the emergence of path-breaking Schumpeterian entrepreneurship. Similarly, it is important to emphasise the key characteristics of entrepreneurial alertness if we are to try to understand the impact of different institutional frameworks on it. Entrepreneurial alertness is non-deployable and tacit, it is costless, people who have it cannot be identified *ex ante*, and it cannot be treated in terms of demand and supply curves. The non-deployable and tacit nature of

entrepreneurial alertness, in particular, has profound consequences for institutional analysis. First and foremost is the fact that the potential stock of entrepreneurial alertness in a society cannot be usefully treated as some 'available' quantity of a resource that is to be allocated and used by an economic system. Rather entrepreneurial alertness is embedded in the decisions of individuals so that their actions simply reflect their entrepreneurial hunches (Kirzner 1983b: 64–66). Entrepreneurial alertness 'somehow emerges into view at the precise moment when decisions have to be made' (p. 66).

This property of entrepreneurship in turn implies that the potential stock of entrepreneurial alertness in a society cannot be measured objectively. Thus, it is not possible to derive quantitative relationships between measures of a society's stock of entrepreneurial alertness and institutional variables (such as its degree of economic freedom), although it is possible to enquire analytically into how the institutional framework may affect the alertness in which decisions are implanted. Another characteristic of entrepreneurship that has a major impact upon institutional analysis is that alertness is costless in the sense that no resource inputs are involved in making entrepreneurial discoveries.

Entrepreneurs discover profit opportunities, hitherto overlooked, without a deliberate search for information. One implication of this feature of entrepreneurship is that operating rules (e.g. public policies, such as subsidies or R&D tax write-offs) which aim to reduce the so-called costs of entrepreneurship or search costs do not necessarily increase the supply of pure entrepreneurship because the latter is costless. The costs of entrepreneurship itself cannot be reduced by public policy or any other means. In addition, it should be noted that price discrepancies and the resultant opportunities for entrepreneurship cannot be wholly explained in terms of high positive transaction and information costs. For even in a market with zero transaction costs, mutually beneficial exchanges between buyers and sellers might still fail to take place (and hence scope for entrepreneurial alertness may still arise). To have access (even access at zero cost) to information about trading opportunities is by no means sufficient to ensure that these opportunities will ever be discovered and exploited. (Free) access to information does not correspond to instantaneous perception and awareness of the usefulness of that information (Kirzner 1973: 227). The implication is that if one institutional framework has lower transaction costs than another, it may not necessarily generate more entrepreneurial activity. If the members of a society were so blinkered that they failed to exhibit one iota of alertness, there would be no

discovery of even the most blatant profit opportunities, even under ideal conditions of zero transaction costs. How the entrepreneurial function is conceived can also influence how we assess an institution's comparative effectiveness in evoking entrepreneurship. For example, if entrepreneurship is considered to be an element inherent in all decision-making (including that by consumers, producers, labourers, etc.), then an institutional framework should be assessed for its relative capacity to foster all types of economic agents to exercise their entrepreneurial faculties. However, if we identify entrepreneurship with the aptitudes of only a small fraction of the population (i.e. 'pure' entrepreneurs), then we must assess the degree to which an institutional framework generates individuals who are representative of the entrepreneurial type and the extent to which it excites their alertness. Different operating rules (e.g. immigration policies) will affect the size of the pool of potential entrepreneurs available to a society. Having explored the major implications of the characteristics of alertness for institutional analysis, we can now move on to consider how institutional conditions affect people's agency beliefs and the degree of their alertness.

4.1.3 Rule-of-law constitutions

According to the argument developed here, the institutional environment that is most likely to produce entrepreneurs is one that calls for and encourages strong agency beliefs. Personal agency beliefs reflect a person's sense of causal potency. They comprise a set of beliefs about the contingency of events on actions (i.e. locus of control beliefs) and about one's personal competence to undertake the relevant actions (i.e. self-efficacy beliefs). It was argued that alertness is an increasing function of the strength of agency beliefs. That is, people with a strong sense of internal control and personal efficacy tend to be more alert to opportunities. This chapter extends this analysis by considering the effects of the institutional framework on people's agency beliefs and thereby their entrepreneurial alertness and behaviour. The implication is that personal agency beliefs and entrepreneurship are endogenous; they can be influenced by political, economic and social variables. As mentioned earlier, the constitutional framework comprises general principles and ideals that people in the community have committed themselves to and that they respect. These principles determine the underlying rules, which specify the political, legal and economic systems of a society and therefore the basic rights of its members. Although

these general principles are contained in the constitutional framework, this does not mean that they are necessarily articulated in any constitutional documents. Indeed, these principles are often only vaguely perceived. ‘Constitutions are based on, or presuppose, an underlying agreement on more fundamental principles – principles which may never have been explicitly expressed, yet which make possible and precede the consent and the written fundamental laws’ (Hayek 1960). For example, a social consensus about the dimensions of the private sphere of the individual might underpin a rule-of-law constitution that frames entrepreneurial and market activities. Following Kirzner (1992), this work regards freedom as the most important political, legal and economic ideal and constitutional principle that is conducive to entrepreneurship. Indeed, freedom can be considered to be the source of and necessary condition for all other entrepreneurial values, and it is to this general principle that the discussion now turns.

The principle of freedom

The central hypothesis is that an environment of freedom, and especially economic freedom, is more likely than other environments to generate strong agency beliefs and acute entrepreneurial alertness. A condition of economic liberty gives all participants the possibility of acting according to their own economic plans and decisions, so that they may direct their energies towards goals that they themselves have chosen rather than towards necessities imposed by powerful others. In an environment of economic freedom, people are more likely to be able to use their skills and knowledge as successfully as possible in the pursuit of their economic ends. Indeed, entrepreneurship in the modern market economy could not exist without a constitutional framework that grants individuals and groups of individuals a large amount of economic freedom. On the other hand, entrepreneurship is likely to be stifled in conditions where many people are irrevocably subject to the arbitrary will and aggressions of others. People are much less likely to develop a strong sense of agency and hence heightened alertness to economic opportunities if they are constantly coerced into acting or not acting in specific ways by somebody else who has the power to manipulate their environment. The term freedom has not yet been defined. We must take heed of Leoni’s warning that ‘we cannot use the word freedom and be rightly understood without first defining clearly the meaning we attach to that word’ (1972). This work adopts his definition of freedom as absence of constraint exercised by other people, including the authorities, over the private life and business of each person. The terms

freedom and liberty will be used interchangeably. Of course, freedom does not imply the total absence of constraint. There are cases in which at least some people may have to be constrained in order to preserve freedom and to protect individuals from coercion by others, such as murderers or robbers. This also suggests that any analysis of freedom must take into account people's subjective perceptions of the degree of freedom that they enjoy. 'There is no such thing as "freedom" independent of the people who speak of it' (Leoni 1972). At least to the extent that their own interpretation of freedom and of constraint differs from that prevalent within the society to which they belong, some individuals must experience some constraint over their behaviour, even within a 'free' society.

Although freedom is a negative concept – because it describes the absence of something, namely coercion by other people – freedom becomes positive through what people make of it. Freedom can become a shared part of economic, political and ethical life, an ideal that continually brings people together and that provides infinite opportunities for them to cooperate and to adapt themselves to one another, thereby unifying a society (de Tocqueville 1990b). Entrepreneurs in particular may make their most valuable contribution to society by exercising freedom that is seldom used by others. Freedom does not guarantee people any particular opportunity or capacity to get what they want but it allows people to decide for themselves how best to make use of their particular circumstances for their own purposes. Freedom is a sociological concept that refers to the social relations between one person and other people. It is also, and possibly chiefly, a legal construct because it implies a skein of legal consequences. The law is the most important institution for attempting to protect individual freedom. 'The law is an order of human freedom' (Karl Binding, as quoted in Hayek 1973). Liberty exists according to the law of a society and is defined by it. There can be no liberty without law. 'The law, in the most general sense of the word, is the science of liberty' (Beudant 1891). Unless specifically indicated otherwise, the emphasis in this work is upon economic freedom. The key elements of economic freedom include freedom of entrepreneurial choice, freedom to enter and compete in markets, adherence to the rule of law, the protection of property rights, freedom of exchange and freedom of contract. Economic freedom is to be distinguished from political freedom which encompasses such ingredients as the freedom of opposition parties to organise and compete and the participation of citizens in the electoral process.

The rule of law

The rule of law is the legal embodiment of freedom and the basic conception of the law of liberty (Hayek 1944; 1960). The concept is open to various interpretations. The first, most common understanding of the term distinguishes the rule or reign of law from rule by arbitrary forms of government. It emphasises the rule of impersonal law as opposed to powerful persons. According to the rule of law, political power can only be wielded within legal constraints so that government is placed under the law.

It limits the functions of government to those that can be carried out by means of general rules. The second distinct, but related, interpretation regards the rule of law as a ‘meta-legal’ principle which serves to guide law-makers. In this sense, it is not strictly speaking a rule of the law but a rule about the law. It is an imperative about the general attributes that good laws should possess:

The rule of law is therefore not a rule of the law, but a rule concerning what the law ought to be, a meta-legal doctrine or a political ideal. It will be effective only in so far as the legislator feels bound by it. In a democracy this means that it will not prevail unless it forms part of the moral tradition of the community, a common ideal shared and unquestioningly accepted by the majority (Hayek 1960).

Thus, the rule of law requires that all laws conform to specific principles though it does not specify what the content of legal rules ought to be. According to Hayek, these principles include the certainty, the generality and the equality of the law. Taken together, these requirements amount to the ideal of the universality of the law. The rule of law is the prerequisite for the concrete rights of the individual, including those economic freedoms that are most important for entrepreneurship. ‘The rule of law can be compared to a tree which, from the invisible strong roots of freedom, lets the fruits of liberty branch out and grow and shine in splendor’ (Dietze 1976). In the absence of the rule of law, public authorities are prone to issue a flood of arbitrary and inconsistent decrees that can dampen people’s sense of agency and therefore their alertness to opportunities:

All too frequently, the unsystematic proliferation of rules breeds sullen conformity and dissimulation of an individual’s true thoughts and motives, a condition that is the opposite of the open competition of ideas and critical assessment of new ideas and experiments; therefore, it is

not conducive to effective coordination and innovation, and hence to prosperity and freedom (Kasper and Streit 1998).

It is worth emphasising that a legal system cannot sustain the rule of law if there are no shared beliefs about justice. In a democracy, the enforceability of rule-of-law constitutions requires that laws be consistent with cultural values and ethical norms that are widely held by members of the community. The legitimacy of government is based on an expectation that it will enforce widely shared beliefs about what is just.

More specifically, as Weingast (1995) argues, the enforceability of constitutions based on the rule of law depends upon the existence of a social consensus about the appropriate limits of state action. In this context, a social consensus does not mean that everyone shares identical values. Rather, there must be a consensus among citizens about which potential actions by the state represent a violation of constitutional constraints as well as a consensus about what they will do to defend the constitution whenever the state tries to transgress its legitimate boundaries. Only then are the constitutional limits on political officials self-enforcing in the sense that those in power have the incentive to comply with the restrictions on their behaviour (Hardin 1989; Ordeshook 1992). Only then is the people's threat of retaliation in the event of a fundamental transgression credible. 'The ultimate sanction on a government is the withdrawal of support by a sufficient portion of its citizens so that the government cannot survive' (Weingast 1995: 26).³ Because it is difficult for citizens to coordinate their views on the legitimate role of the state, the emergence of a consensus is by no means automatic or inevitable. Failure to resolve this coordination problem hinders the enforcement of a rule-of-law constitution. In the absence of a consensus and organised opposition, the state will be able to get away with infringing the rights of all or some citizens, sometimes playing off one group against another. If governments continually succeed in violating constitutional constraints with impunity, citizens are most likely to come to perceive the constitution as a 'book of hopes' with no connection to the real world, as a 'set of desiderata largely irrelevant for actual government behavior' (Voigt 1998).

The certainty of the law

It is desirable to explain what certainty of the law actually means. Leoni (1972) defines certainty of the law as 'the possibility open to individuals of making long-run plans on the basis of a series

of rules spontaneously adopted by people in common and eventually ascertained by judges through centuries and generations'. Certainty of the law means that the law is not subjected to sudden and unpredictable changes. Its incidence is predictable. This conception of legal certainty does not mean, and may even be incompatible with, the notion of a series of precisely worded written rules laid down by legislatures. Indeed, many rules implicit in the body of the law may never be articulated explicitly. The certainty of the law is probably the most important principle for entrepreneurship and other economic activities. 'There is probably no single factor which has contributed more to the prosperity of the West than the relative certainty of the law which has prevailed here' (Hayek 1960). The conventional wisdom is that the legal framework must be sufficiently certain to enable entrepreneurs to make their plans. Entrepreneurs must be able to find out, with reasonable confidence, whether specific actions are either demanded or proscribed by the law. They must be able to foresee with a fair degree of certainty whether their planned conduct is within or outside the law. When the decisions of courts are consistent and predictable, many commercial disputes do not result in litigation because the outcome is already clear once the relevant facts of the case are identified. It should be noted that the certainty of the law does not mean the absence of change, but it does mean that entrepreneurs can make their plans on the basis of present legal rules without finding that the rules have been overturned overnight by legislative U-turns. In short, entrepreneurs can expect that today's legal rules will be tomorrow's rules. A consequence of such certainty of the law is that an inefficient but stable legal rule does not necessarily imply inefficient economic behaviour, provided that entrepreneurs and other participants can bargain around the rule. Consider a legal system in which judges decide cases according to precedent (i.e. by applying rulings from similar cases in the past). As Rizzo (1985) explains, this type of legal order can promote the entrepreneurial processes that generate coordination of economic action because it enforces a stable framework of legal rules against which private economic actors can bargain, assuming low transaction costs of exchange. The market prices of goods and services can be in constant flux, but provided that the institutions governing market exchanges are relatively stable, entrepreneurs will by and large be able to adapt to new circumstances and bring about greater consistency in market transactions in different parts of the market. 'The seas may be choppy, but so long as the buoys are anchored firmly navigation can proceed safely' (Wagner 1998). Incessant and unpredictable changes in laws render entrepreneurs unable to use legal rules to orient themselves in making their plans. As

discussed later, retrospective (ex post facto) laws in particular flagrantly contravene the principle of legal certainty. In order to exploit perceived profit opportunities, innovators in particular must often plan many years into the future. Innovative entrepreneurs need to foresee that the result of actions decided upon today will be free from legal interference by the authorities tomorrow. The greater the certainty of the law, the more confident they can be of the legal effects of their innovative behaviour, and the more likely they are to discover and to exploit opportunities which involve coordinating transactions entered into at different times. However, the relationship between the certainty of the law and entrepreneurship is not quite so clear cut. For instance, single-period arbitrageurs can benefit from accelerated and unpredictable law-making processes which give rise to temporary profit opportunities. This is particularly the case with those entrepreneurs who specialise in the more or less instantaneous discovery and exploitation of tax loopholes created by legislative changes. Speculators too may benefit. Speculative entrepreneurs may seek to profit from legal uncertainty – the uncertainty that current statutes may be replaced at any stage by subsequent laws – especially if they believe themselves to have superior hunches about potential legal developments. There is thus an element of apparent indeterminacy in the effects of legal certainty upon entrepreneurship. Although this difficulty is still to be resolved satisfactorily, some preliminary conjectures can be put forward now in the interests of furthering the debate. In the first instance, it seems that expedient changes in legal rules affect what were earlier referred to as ‘demand-side’ institutional conditions. They relate to the structure of economic circumstances and incentives in the market environment. More formally, these legal changes constitute exogenous disturbances in Kirzner’s model of the economic system. They disrupt people’s previously coordinated plans and generate fresh opportunities for pure gain. As such, they create scope for entrepreneurial activity. However, the mere existence of these opportunities is not in itself sufficient to generate entrepreneurial activity – especially if we take into account the possibility that no one may become aware of these opportunities. Some profit opportunities arising from changes in legal rules may never be discovered. In addition, the entrepreneurial discovery process that is set in motion by successive ad hoc regulatory and legislative changes may be ‘wholly superfluous’, in the sense that they create entirely new profit opportunities that would not have existed in the absence of these changes (Kirzner 1985).

The generality and equality of the law

General and equal laws abstract from the specific circumstances of time and place, and they apply, in a non-discriminatory manner, whenever certain abstractly defined conditions are met (Hayek 1955). This is clearly an ideal. In this sense, good laws are like universal scientific hypotheses: they are general rules rather than specific schemes relating to the state of the world at particular times and places. Indeed, generality is the most significant feature of the abstract character of law. The generality and equality of the law are important for entrepreneurship especially given that it is not possible to preselect entrepreneurial individuals. General abstract rules are applicable to an unforeseeable range of entrepreneurs and innovative cases. These rules do not make any references to particular persons. Similarly, a fundamental characteristic of entrepreneurship in modern market economies is that entrepreneurs are not known in advance. They are generally those who are alert to possible opportunities. As a result, many unknown entrepreneurs may take part in attempts to solve any particular market problem. Because it is not possible to identify entrepreneurs *ex ante* (at least for any particular market opportunities prior to their discovery), it is essential that the institutional framework provide each person with the maximum freedom of enterprise compatible with equal freedom for all other people. The equality of the law is aimed at equally improving the chances of as yet unknown entrepreneurs. General and equal laws provide the most effective protection against encroachment of the state on individual liberty. The ideal of the rule of law requires that the state act under the same law and therefore be limited in the same manner as any private person. It thereby restricts the coercive activities of government:

It is not to be denied that even general, abstract rules, equally applicable to all, may possibly constitute severe restrictions on liberty. But when we reflect on it, we see how very unlikely this is. The chief safeguard is that the rules must apply to those who lay them down and those who apply them – that is, to the government as well as the governed – and that nobody has the power to grant exceptions. If all that is prohibited and enjoined is prohibited and enjoined for all without exception ... and if even authority has no special powers except that of enforcing the law, little that anybody may reasonably wish to do is likely to be prohibited. (Hayek 1960: 154–155)

The generality of the law reinforces its certainty. General laws are more predictable than specific, ad hoc commands issued by a public authority. By specifying beforehand the circumstances in which action must satisfy certain conditions and providing the framework within which entrepreneurs can form their plans, general rules make the legal consequences of entrepreneurial action more predictable. The requirement of general and equal laws for all persons is conducive to freedom, a strong sense of personal agency – particularly internal LOC beliefs – and hence entrepreneurship. Under the rule of law, entrepreneurs know that their sphere of personal agency (i.e. the area of legally guaranteed freedom) includes all actions not explicitly prohibited by general legal rules. Because general laws specify beforehand the conditions and the manner in which people can expect to be coerced, entrepreneurs can determine with reasonable confidence the boundaries of the law within which they can exercise their own will and causal powers. They also know that these boundaries apply equally to everybody. In this way, general laws allow entrepreneurs to make the best use of their own unique competences and localised knowledge in their seizing of profit opportunities. In a society governed by the rule of law, entrepreneurs know that their actions do not depend on gaining the permission of any government authority (provided they keep within the legal delimitation of their private sphere of agency). In addition, entrepreneurs know they will not be subject to sudden administrative orders directing them personally to undertake specific actions. It is true that general rules might eliminate some options otherwise open to entrepreneurs. But the point is that they do not constrain the choice sets of entrepreneurs to such an extent that their preferred course of action will and must be that which most benefits some external authority (Hayek 1960: 133, 153). Entrepreneurs do still have genuine choices to make. The contracts they conclude are entered into voluntarily, as acts of entrepreneurial autonomy. General, abstract laws are long-term rules and are only ever forward looking in their effect. General rules guide entrepreneurial action; they are data that entrepreneurs can use as a basis for their planning activities. In contrast, retroactive legislation cannot affect entrepreneurial action, since entrepreneurs have already taken and implemented their decisions prior to the promulgation of such laws. Retrospective legal rules add to entrepreneurial uncertainty since they undermine the standing of laws that are prospective in their effect; the likelihood of retrospective legislation, by definition, places existing and subsequent forward-looking legal rules under the threat of retrospective changes (Fuller 1964: 38–39). The retrospective enforcement of changes in the law significantly inhibits

entrepreneurial freedom and autonomy, and it diminishes entrepreneurs' sense of personal agency. In the first instance, their LOC beliefs become less internal because the outcome of market transactions is seen to be vulnerable to the whims of those in power. In particular, entrepreneurs come to perceive that the legal consequences of their transactions are less contingent upon their knowledge of existing law and their understanding of just conduct. In addition, their sense of self-efficacy is likely to fade because entrepreneurs feel they never know the legal rules that they are expected to observe. They are unable to plan their actions by relying upon the application of pre-existing law. The dampening of personal agency caused by the abuse of retrospective legislation thereby inhibits alertness to market opportunities. The requirement of general and equal laws also implies the absence of privilege and arbitrary discrimination. General legal rules do not single out particular entrepreneurs or groups of entrepreneurs.

4.1.5 The institution of private property

A high-level entrepreneurial environment requires more than just an anonymous price system comprising faceless traders. The communication of information on markets and the governance of entrepreneurial transactions also require a diverse set of supporting institutions:

Prices and markets function as part of a social system, not in isolation. A social system generates many kinds of signals and rules besides prices. ... Non-price constraints are as much a part of a decentralized economy as are the prices they help to generate. These constraints are reference frameworks and orientation points, in terms of which actors form expectations. Prices are formed on markets composed of contracts, rules, and customs, which are part of the constraints and basis for observed behaviour. ... [Nonprice] constraints are often necessary accompaniments to markets. For example, it is strictly impossible to imagine a 'price system' devoid of contracts and property rights. (O'Driscoll and Rizzo 1996: 106; emphasis added)

Although prior ownership of property is not a prerequisite to entrepreneurial alertness, entrepreneurs would not be able to formulate or carry out their plans unless they were reasonably sure that the people with whom they trade have exclusive control over the relevant resources. In order to reallocate resources in the pursuit of profit, entrepreneurs must often purchase exclusive rights to assets in one period with the intention of selling them for a higher price in a subsequent period. Before the act of purchase, the entrepreneur will need to establish who owns those assets.

Having purchased those assets, the entrepreneur will want to be certain of his or her exclusive control over them until the date of their sale. And when selling those assets, the entrepreneur will need to be confident of the claim of the buyer to the resources that are being offered in exchange for those assets. Thus, to be in a position to carry out their plans of action, entrepreneurs must rely upon a secure system of property rights.

Principles embodied in the concept of private property

The institution of private property is an essential condition for safeguarding individuals against coercion and protecting liberty. 'While property in some form is possible without liberty, the contrary is inconceivable' (Pipes 1999). As the term implies, private property rights are held in a private capacity by individuals, a group of people or a firm. They are to be distinguished from public rights, which are exercised by those who control the state or one of its political organs. As discussed later, the distinction between these two types of rights and the relative prevalence of these rights have important implications for the nature of the economic system and the scope and character of entrepreneurship. The institution of private property embodies two main principles. The first is that people have an assured private sphere of things which they can control and which we call their property ('the right to control and benefit from resources'). One's private sphere consists of those things in one's environment with which others cannot interfere. The second principle is that these things can be transferred from the sphere of one person to that of another only by mutual consent ('the right to dispose of resources') (Hayek 1955). Although they guarantee a certain area of freedom, these principles do not constitute absolute property rights. Under very exceptional, narrowly defined circumstances, such as war or imminent peril to life, the state and private individuals may be permitted to infringe the property rights of others in exchange for some form of just compensation. The institution of private property (and the principles it embodies) has an important psychological dimension that enhances our feelings of self-efficacy, internal control and personal agency, and it thereby promotes entrepreneurial alertness. Private property rules offer people the possibility of self-determination or autonomy. 'For it is by using one's own property according to one's own values and goals, without the necessity for consultation with one's neighbour, or any collective authority, that one can most nearly approximate the status of an autonomous agent' (Gray 1989). Ownership of property causes objects that we possess to become part of our protected private sphere. By controlling,

exploiting and transferring property, we can express our subjective sense of agency in the external material world of physical and intangible assets and can carry out, with varying degrees of success, the tasks necessary to sustain ourselves. When our right to own and control property is curtailed or taken away from us, we experience a dilution of our sense of personal agency.

The psychological aspect of the institution of private property (especially as it relates to consumer goods) is evident in early stages of child development, in both individualist and group-oriented cultures (Gesell and Ilg 1949; Spiro 1975). Empirical studies of children have found that psychological attachment to property (i.e. feelings of ownership) is closely associated with the development of personal identity and a perception of the contingency of events upon one's own behaviour: 'The first notions of possession revolve around what I control and what responds to my actions' (Furby 1980). In addition, Furby's studies found that, across different ages and cultural groups, a sense of personal competence and efficacy was fundamental to one's understanding of, and motivation for, possession and property. The second principle embodied in private property rules implies that people have the freedom to transfer the things they own to others. It thus presupposes that property is alienable. The alienability of property means that people are able to separate themselves from the things that they produce, so that they do not have to consume their own output. Thus, they are willing to sever the connection between the production of a good and the consumption of its services in order to obtain gains from trade. What people produce with their own labour is objectified and depersonalised, so that they are willing to make it available for use by others and to claim title to goods that they did not produce themselves (Casson 1990). The alienability of property is essential for fostering markets and for facilitating the entrepreneurial processes to coordinate market transactions.

Economic versus legal structure of property rights

The conception of property rights most relevant to entrepreneurship is economic rather than legal. The economic notion is broader than the legal conception of property rights as defined in the laws of various societies. In essence, an economic property right gives an entrepreneur the effective decision-making authority or actual power to choose the uses of an economic good, to draw the fruits from its use and to transfer the good to other people. This right is of crucial importance if entrepreneurs are to be free to exploit opportunities for reallocating specific capital goods from low-valued uses to new, hitherto unimagined, higher-valued uses. The economic

conception of rights is the one most akin to the notion of internal LOC, competence and personal agency. Because economic property rights give an entrepreneur the freedom to capture profit from trading an asset and to contract over the terms with other participants, they strengthen the entrepreneur's perceptions of the contingency of potential economic rewards upon their actions, thereby increasing their internal LOC and alertness. Economic rights may be, but are not necessarily, supported by registered legal title or formal laws enforced by the state. These rights constitute defacto ownership of assets and may or may not correspond to legal definitions of property (i.e. de jure ownership). 'While property in the legal sense of the word has something to do, and particularly historically had to do, with the property in the economic sense of the word, the legal structure of property does not reflect necessarily its economic counterpart' (Bajt 1968). Indeed, economic rights can be maintained by means of physical force and the threat of social sanctions, such as ostracism. In contrast, legal property rights are defined as what the legal authority or system formally recognises and enforces as a person's property. In the legal sense, private property rights 'designate the legal institution in which the main economic rights in a resource are bundled in the hands of a single title holder' (Mackaay 1997). For many types of transactions, legal rights can reduce the costs of contracting, especially with strangers, because they facilitate third-party enforcement primarily effected through the courts. Although legal rights are neither necessary nor sufficient for the existence of economic rights, the delineation of legal rights can in general enhance economic rights, people's perceptions of personal agency and hence entrepreneurial processes. 'Markets without clearly defined rules tend to be limited and constrained as vehicles for economic development' (Boettke 2001).

Economic decentralisation and private versus public (state) property rights

The scope for entrepreneurship and its character also depend upon the relative importance of different types of property rights in an economic system. As mentioned earlier, the private–public continuum is one of the most important dimensions over which property rights can vary. Capitalist economies depend upon private property rights, whereas socialist and communist systems stress public property rights. Only within a decentralised system of private property are productive resources voluntarily exchanged in real markets against money, thereby enabling entrepreneurs and other market participants to attach meaningful prices to them. 'The existence of markets for productive assets is the most important feature of a market exchange system based

on private property, capitalism' (Eggertsson 1990). Market prices for productive resources reflect the interplay of the subjective valuations of all the individuals participating in buying and selling. The existence, in different parts of the market, of multiple money prices for the same bundle of private ownership rights over an asset represents a simple arbitrage opportunity. Indeed, entrepreneurial profit presupposes the institution of private property and associated market prices. The institutions of private property and money are essential for guiding entrepreneurs in their judgements of the potential profitability of alternative ventures (i.e. the process of monetary 'economic calculation'). In contrast, a socialist system of economic organisation is based on constitutionally established public or state ownership of the means of production, which implies the absence (or constitutional abolition) of private property rights, markets and market prices for productive resources. In its pure form, the state is the exclusive owner of all productive assets and the allocation of these assets is orchestrated by the one central planning authority only. It is only the imagination and alertness of a single mind – namely, that of the central planner – that shapes the pattern of decisions made within the single attempted plan. However, without markets for productive resources, the socialist-planning agency cannot allocate resources rationally. Because it lacks indices of the relative importance of those resources (i.e. market prices for factors of production), it is unable to reallocate scarce resources to highervalued uses as economic conditions change. 'Every step that leads away from private ownership of the means of production and the use of money is a step away from rational economic activity' (Mises 1981). In the absence of market price signals for capital goods, the central authority has no basis for reckoning the results of its planned actions. The agency has no basis for determining the full implications of one set of decisions for other decisions in its overall plan (Kirzner 2000). Consequently, even if the central agency's objective were to satisfy as much as possible the wants of consumers in the socialised economy, its plan would necessarily fail. The legal structure of property rights under socialism offers no scope for the decentralised entrepreneurial acts of discovery, motivated by the lure of pure profit, that involve trading bundles of ownership entitlements. Agents in the socialised economy are legally precluded from holding and trading property and from keeping the entrepreneurial gains from such activity:

Government officials whose status, by definition, precludes their being able personally to profit from their commercial discoveries, cannot be depended upon to achieve through planning, or through bureaucratically setting nonmarket 'prices' to stimulate effective market activities, those

discoveries the generation of which constitutes the real contribution of free markets (Kirzner 2000).

The moral dimension of private property rights

Property rights do not evolve in a moral vacuum. The definition and enforcement of property rights requires a socially recognised notion of ownership and shared ethical principles. ‘The core of the institution of ownership is a matter of unquestioned and largely unconscious social and economic practices that must be rooted in non-legal developments’ (Rapaczynski 1996). According to John Stuart Mill, the institution of private property is founded on the notion that producers have a moral right to what they themselves have produced. Typically, in the literature this is taken to mean that people have a just title to what is produced by the resources they themselves own, including their own labour. Kirzner rejects this identification of production solely with what derives from the ownership of factors of production. He consequently rejects the ‘factor ownership’ theory of property to which it gives rise (including Locke’s labour theory) and its ethical implications. The reason is that this conception of production and its associated theory of property exclude the exercise of pure entrepreneurship in production (which involves no resource ownership) and the entitlement of entrepreneurs to what they have discovered.

In sum, entrepreneurs have a right to own what they have discovered with their own alertness. A widely shared moral conviction that recognises the justice of this ‘finders-keepers’ rule as well as the injustice of confiscating what someone else has discovered reinforces a strong sense of personal agency in entrepreneurial endeavours. The discussion below on the freedom of contract examines the finders-keepers principle more closely.

There are two opposing views about the underlying conditions that precede the emergence of the entrepreneurially driven market economy. The first approach, to which Kirzner subscribes, holds that the requisite ethical norms and social institutions (e.g. property and contract rights) must preexist in a society before markets and market entrepreneurship can emerge. The rival view is that the institutional conditions conducive to market entrepreneurship can be generated spontaneously as a by-product of the market process itself. According to Kirzner, property rights are largely rooted in an extramarket ethical framework, so that there is an overriding moral basis for the assignment and evolution of property rights.

It is important to note that the economic assets to which property rights refer are not unidimensional (Barzel 1997). These assets typically have multiple attributes, and there are often separate rights to different attributes of any given asset. Consequently, the experimental rights or fences that entrepreneurs might introduce in the pursuit of profit opportunities do not necessarily cover novel products as such but may be aimed at securing control over new attributes of existing assets that have only just been discovered. According to the condition of presumptive control, the owners of existing assets are presumed to hold any future, but as yet unknown, rights to newly discovered attributes of those assets when those rights come into being (Demsetz 1998: 146). Thus, the development of property rights systems is a dynamic and open-ended process.

4.1.6 Freedom of contract

The freedom of contract is an essential component of economic liberty and is pivotal to entrepreneurial processes in a modern market economy. Contractual freedom means that entrepreneurs and other market participants are free to pursue their own interests through making binding promises, however prudent or imprudent, in the course of economic transactions. It gives entrepreneurs and other market participants the freedom to place themselves under a legal, and perhaps moral, obligation regarding their future conduct (thereby voluntarily reducing the possibilities open to them in the short run) for the purpose of expanding their range of choices in the market later on. It goes without saying that the freedom of contract guarantees neither entrepreneurial success nor any preconceived outcome.

Freedom of contract and entrepreneurs' personal agency beliefs

Like the institution of private property, the freedom of contract evokes feelings of internal LOC and reinforces people's propensity to be alert to opportunity. The concept of contract is one of the most important means that the law offers people to control their own destiny: 'The whole network of rights created by contracts is as important a part of our own protected sphere, as much the basis of our plans, as any property of our own' (Hayek 1960: 141). By voluntarily adhering to the rules of contract law, a person can broaden the scope of their protected domain. 'Inasmuch as he validly contracts, his claims on others become, as it were, an extended "property right" (just as their claims on him become part of their extended property rights)' (Rizzo 1985: 869). If defining and specifying property rights is the central economic function of the law of

property, then providing for the transferability of those rights to higher-valued uses is the main economic function of the law of contracts. In order to be able to advance their plans, entrepreneurs must be able to enter binding commitments with the holders of property rights over resources that have the potential for improved coordination. That other people's property can be hired or sold to other market participants in the achievement of entrepreneurs' aims is largely due to the enforceability of contracts. By enforcing long-term promises, the judicial system enables entrepreneurs and other market participants to make credible commitments to cooperate with each other. In other words, contract law provides the legal scaffolding that helps contracting parties to invest in the physical and human capital that is specific to particular entrepreneurial transactions and relationships. Such investments have the potential to enhance the gains from trade since the cost of supply from highly specialised capital (e.g. customised plant and equipment) is presumably lower than that from fungible (i.e. multipurpose) capital items. But because specialised capital goods cannot, in the event of a breakdown of exchange relations between the entrepreneur and the other party, be redeployed to alternative uses or users without a significant loss of productive value (perhaps because there is no lease or resale market), the party making such investments is tightly locked into the transaction and is exposed to the threat of ex post hold-up by the other contractual partner (Williamson 1979; 1985). In the absence of legal safeguards upon which they can rely, parties who anticipate such opportunistic behaviour may be unwilling to sink resources into relationship-specific investments. 'Many substantive contract doctrines, ranging from the traditional common law's pre-existing duty rule to the modern duty of good faith, are designed to provide precisely this protection' (Katz 1998).

Freedom of contract and the rule of law

The freedom of contract is derived from the rule of law. Freedom of contract ... means that the validity and enforceability [sic] of a contract must depend only on those general, equal, and known rules by which all other legal rights are determined, and not on the approval of its particular content by an agency of the government.

Entrepreneurship, contractual mistakes and non-disclosure

Preserving incentives for speedy entrepreneurial discovery requires general, equal and certain rules of contract that allow entrepreneurs to take advantage of market ignorance. In considering

this principle, it is useful to consider cases involving unilateral mistake and non-disclosure, which arise when one party, say the purchaser, simply remains silent and lets the unsuspecting seller contract on the basis of a mistaken belief concerning relevant material facts. For example, suppose that a team of entrepreneurs has a strong hunch that a block of land might contain valuable subsurface mineral deposits and suppose further that the entrepreneurs know that the current owner is completely unaware of its mineral-bearing potential at the time of contract formation. (Assume, for the sake of argument, no duress, fraud, misrepresentation or breach of fiduciary duty on the part of the entrepreneurs or cognitive incapacity on the part of the seller.) The entrepreneurs contract for the purchase of the land at a low price that reflects only its existing agricultural uses and, upon finding their earlier hunch to be correct, they subsequently sell the property at a much steeper price signalling its higher-valued use as a mineral reserve. At the normative level of philosophical and ethical evaluation, permitting the entrepreneurs to capture the arbitrage profit arising from the other contracting party's genuine error does not deprive that party of the freedom necessary to make his or her promises entirely voluntary and binding – at least not if the relevant concept of voluntary consent is grounded in Kirzner's theory of distributive justice. As mentioned earlier, Kirzner's finders-keepers ethic insists that entrepreneurs have full title to the 'discovered gain' that they unearth as a result of superior alertness. The gap between the prices that entrepreneurs pay and receive for resources represents pure arbitrage profit and is a gain that is spontaneously discovered solely by them without deliberate search:

The additional value now seen by all to have resided in the resource was in fact found by the innovative entrepreneur. If we follow a finders-keepers rule we can no longer countenance any simple revocation of the resource sale. Simply to revoke the sale will be to assign to the seller a gain which someone else, not he, discovered. Precisely because the seller had no inkling of the 'true' higher value residing in his unit of resource he must recognize that the gain to be derived from the discovery of the higher value, justly belongs to another under a finders-keepers rule.

Contract enforcement

It should be noted that the freedom of contract in the legal sense does not just comprise the freedom of individuals to use available types of contracts for their own purposes. It also refers to the types of contracts that the legal authority will enforce. For example, in modern Western

societies, the state does not try to enforce all classes of contract, such as contracts for criminal purposes, gambling contracts, price-fixing agreements and liability insurance policies against fines. In the case of contracts to sell voting rights and human organs, the state intervenes to such an extent that it prohibits the market exchange of these entitlements under all circumstances, even between a willing seller and a willing buyer. In the terminology of Calabresi and Melamed (1972), rules of inalienability protect the entitlement, even against the owner's temptation to sell it. By barring contracts to trade these legal entitlements, inalienability rules may be thought of as attenuating the grant of the entitlement itself. The focus so far has been on the role of the judiciary in enforcing contracts, but there are other mechanisms besides the courts for governing contractual relations. State-supplied or judge-made contract laws often serve as a comprehensive set of default rules around which entrepreneurs and their trading partners can contract. The public legal system for enforcing contracts is far from perfect, and judicial enforcement of contracts (i.e. 'court ordering') is costly. Contracts can be enforced unilaterally, bilaterally or trilaterally. (However, these mechanisms generally still presuppose that the state will uphold the freedom of contract and set the legal baseline of entitlements in the event of possible judicial enforcement.) Unilateral or internal governance of contracts occurs when two contracting parties belong to the same hierarchical firm (e.g. a business start-up) established by the entrepreneur and are both subject to the authority of the latter when contractual difficulties emerge. Unilateral governance also includes the use of the household, extended family network or clan to govern economic transactions in the absence of de jure property rights. When both sides of a transaction to supply an input are contained within a single organisational entity, the entrepreneur can exercise greater control over whatever quantity adjustments are needed as economic conditions change. Entrepreneurs and other participants may also depend upon bilateral governance structures. They may resolve their contractual disputes directly themselves through 'private ordering' and might only turn to judicial enforcement of their contracts as a last resort. Entrepreneurs' reliance upon self-enforcement mechanisms to ensure fulfilment of bilateral contracts rather than external enforcement organisations, such as the courts and police, preserves their autonomy and it may enhance their feelings of internal control over how unanticipated events will be handled. The freedom to engage in private ordering may thus strengthen entrepreneurs' sense of agency and their alertness to opportunity.

Indeed, many, if not most, contractual disputes that could be litigated under current law are resolved by private means, such as ‘tit-for-tat’ strategies, the threat of terminating the business relationship altogether, or self-help. The reason why private ordering is so common is that in ‘many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute’ (Galanter 1981: 4). In addition, entrepreneurial contracts are also facilitated by the development of private trilateral governance structures to which traders have the right of recourse in the event of contractual disputes, thereby reducing transaction costs. A good example is the range of third-party arbitration tribunals that exists for resolving disputes under private commercial law. In the USA alone, merchant entrepreneurs and managers in more than fifty industries, including diamonds and cotton, have opted out of the public legal system and, through their trade associations, they have collectively developed systems of private commercial law (Bernstein 1992; 2001). These systems each comprise a network of contract default rules that are specific to the particular industry. Merchant arbitration tribunals operated by trade associations interpret and enforce these rules as codified by industry trade rules. The private commercial law systems still operate within the ambit of the public legal system in that the awards of merchant tribunals are legally enforceable by the courts. (To this extent at least, entrepreneurs operate within a state-provided superstructure of the law of contracts within which there is a plurality of decentralised private systems of contract laws.) However, a party rarely needs to seek judicial enforcement of a tribunal’s decision because formal and social sanctions are so effective. The next chapter examines more closely decentralised processes for the production and enforcement of legal rules and their consequences for entrepreneurship. This concludes the discussion of the institution of private property and freedom of contract. The next chapter takes a different tack. It focuses upon the phenomenon of money and the political decentralisation of economic regulatory authority, and it examines the impact of these institutional factors upon the development of personal agency beliefs and entrepreneurial alertness. It also considers the substantive economic liberties, conducive to entrepreneurship, that are provided by an institutional framework based on the rule of law, the institution of private property and freedom of contract.

4.2 Institutions II: Money, political and legal decentralisation and economic freedom

4.2.1 The phenomenon of money

Money is one of the key institutions contributing to human freedom and the development of civil society. It is one of the great social phenomena that rationalise economic life:

It [the use of money] gives society the technical machinery of exchange, the opportunity to combine personal freedom with orderly cooperation on a grand scale, and the basis of that system of accountancy which Sombart appropriately calls 'economic rationalism' (Mitchell 1937).

It plays a significant role in the cultivation of entrepreneurial alertness and the ability to make judgemental decisions about the coordination of economic resources. In the absence of money, a complex economic order based on specialisation and the division of labour could not emerge. The scope for entrepreneurship would be limited to an extremely rudimentary form of production and exchange.

The analysis of market entrepreneurship has also assumed implicitly that money is 'neutral': that is, that the working of the market and the direction of market activity are exactly as they would be in the absence of money. It should be noted that these assumptions were made for heuristic purposes only. In the real world, the introduction of a money supply into a market system affects both demand-side and supply-side conditions conducive to entrepreneurship. Because it induces changes in the degree of division of labour and specialisation in production and exchange, the division of knowledge among market participants, the extent and number of markets and goods, the duration of the period of production (degree of 'roundaboutness'), and the transaction costs of exchange, money changes the structure of economic circumstances and the totality of exchange ratios between commodities that give rise to entrepreneurial opportunities. To state it simply: the emergence of money increases the range of goods and services available on the market and the potential set of disequilibrium prices open for correction. It thereby increases the scope for entrepreneurial opportunities. The existence of money promotes personal agency by enhancing entrepreneurs' perceptions of self-efficacy and particularly their beliefs about their own capacity to secure the relevant knowledge, to plan rationally and to coordinate resources successfully in the pursuit of profit opportunities. In addition, a generally accepted medium of exchange bolsters entrepreneurs' perceptions of the contingency of desired economic outcomes (profit, success) upon entrepreneurial actions. It

raises their expectation that economic rewards are controlled by behaviour rather than external forces. In other words, it reinforces an internal locus of control.

Money and entrepreneurs' self-efficacy beliefs

Money changes how people think and act because it can reduce the cost of cognition and can serve as a substitute for cognition (Gifford 1999). Money is part of the institutional framework that facilitates the mental division of labour and extends specialisation in cognition. One mechanism by which money affects entrepreneurs' agency beliefs is through its impact on their perceptions of their problem situation. Entrepreneurs' estimates of their self-efficacy and degree of agency may include a cognitive appraisal of the situational context in which entrepreneurship occurs, including the nature of the goals to be achieved and the requirements of the transactions to be carried out. Transactional attributes include the degree of complexity and interdependence of activities, the frequency and number of sequential and coordinative steps necessary, and the quantity and quality of resources and knowledge required to complete the transaction successfully. The adequacy of the resources and knowledge that the entrepreneur has access to in a domain of activity is another contextual factor. Money prices reinforce a sense of efficacy and agency because they improve the epistemic and informational basis of entrepreneurial action. Money prices reduce the amount of detail that entrepreneurs need to know in order to make the right decisions. They make it possible for entrepreneurs to make plans as if they had much more knowledge than they actually do. They increase the ability of entrepreneurs to 'know' their environment, even if that knowledge contains a heavy tacit component. Money prices supply the knowledge base upon which entrepreneurs' cognitive processes can operate, and they condense a tremendous amount of contextual and historical knowledge relating to each good into a single cardinal number (Horwitz 1998). In the absence of money prices, entrepreneurs would have to obtain and aggregate masses of additional data on resource availabilities, production technologies and consumer preferences as the basis for their activities. 'The most significant fact about this system [the price system] is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action' (Hayek 1948; emphasis added). In exploiting the particular price differences and profit opportunities they themselves have discovered, entrepreneurs decide tentatively to treat many observed prices as unproblematic and reasonably reliable. In so doing, entrepreneurs make their plans against a

background of money prices, some of which they single out and test but many of which they accept unquestioningly for the time being. ‘The economy of knowledge with which the [price] system works is due ... to a division of entrepreneurial labor caused by the fact that each individual “disagrees” only with a few prices while “accepting” all others’ (Thomsen 1992). This buffer serves to protect entrepreneurs from cognitive overload, a condition that would threaten their capabilities and self-efficacy (Lavoie 1985b). Money prices signal, more or less faithfully, underlying economic fundamentals.

Money and entrepreneurs’ locus of control beliefs

A system of direct exchange or barter is one in which all market transactions involve ‘the exchange of one useful good for another, each for purposes of direct use by the party to the exchange’ (Rothbard 1993). There is no universally used medium of exchange; money does not exist. Goods and services are directly traded on the market against other goods and services. Each party acquires a good either for the direct satisfaction of his or her wants or for the services it renders directly to the production of other goods. Barter is a very cumbersome and high-transaction-cost system in which every entrepreneurial transaction requires a ‘double coincidence’ of wants. At the very least, the entrepreneur must find two individuals, each of whom possesses a different good, and each of whom simultaneously values the good of the other more highly than his or her own. The fragility of entrepreneurial plans involving barter transactions applies to the production and sale of even the simplest commodities. Within a barter system, the problem is substantially exacerbated in the case of indivisible goods, such as a house or boat. The upshot is that under full barter entrepreneurs consider the success and profitability of even relatively simple transactions to be extremely sensitive to those external forces that can generate significant costs of adaptation. This sensitivity to external shocks dampens their perceived level of internal control, which in turn dims their alertness. In contrast, in a fully monetised economy, the entrepreneur knows, as a result of the tacit agreement among market participants, that others will accept only one particular commodity – namely, the one that serves universally as money – as payment for the other goods and services they supply. Money represents a linking pin in all market transactions.

Discretionary monetary policy and entrepreneurs’ perceptions of agency

It should be noted that the origin of the phenomenon of money is independent of the power of the state. 'Money is not an invention of the state. It is not the product of a legislative act. Even the sanction of political authority is not necessary for its existence' (Menger 1994).

But it suffices to emphasise that not only can money emerge spontaneously out of a barter economy through the interaction of market participants, but also money can only evolve organically through private market exchanges and cannot be consciously created by the state through central planning (Menger 1892; 1994). It is 'epistemologically impossible for the State to create a common medium of exchange outside the context of exchange practice' (Boettke 2001: 255). The state by itself does not have the power to transform a commodity into a generally accepted medium of exchange. Although the legal order of a society can have an effect on the money character of commodities, it is only the common commercial practice of all the individuals who participate in the market that can create money.

One approach to constraining discretionary monetary interventions is to denationalise money and to introduce competition into the monetary sphere.

In addition to providing a sounder banking system and more effective administration of the money supply, a free banking system of competitive note issue is likely to enhance the alertness of entrepreneurs both within and outside the banking sector.⁸ Under free banking, entrepreneurs in the market for monetary services are free from interference by monetary authorities, such as a central bank or a government deposit insurance agency. They have the freedom to issue bank notes bearing their brand name, set interest rates and introduce new types of loans and deposits, subject only to the general laws of contract. Entrepreneurs recognise that there is no official lender of last resort that will provide them with emergency loans if they make poor business decisions. Eliminating the central bank and privatising the money supply credibly signals to all potential entrepreneurs that the government is committed to a limited role in economic affairs. It takes away the ability of the government to finance its expenditures through inflation, and it thereby assures entrepreneurs that government officials will not manipulate the value of the monetary unit and distort the structure of relative prices. All in all, free banking is likely to strengthen entrepreneurs' sense of personal agency and to heighten their alertness to profit opportunities.

4.2.2 Political decentralisation

By itself, the rule of law, even in Hayek's thoroughgoing version, does not secure a system of personal liberty and vigorous entrepreneurship. The rule of law, and the formal requirements it imposes (certainty, generality and equality), does not guarantee an effective bulwark against the discretionary power of government. It is a mistake to present the rule of law as a sufficient condition for individual freedom and the unimpeded operation of spontaneous market forces, when it is possibly only a necessary condition (Hamowy 1971). The same could be said of well-defined property rights and freedom of contract. The fundamental problem is one of credible political commitment to maintaining markets and protecting economic liberties. If entrepreneurs are going to discover lucrative business opportunities and engage in the innovation that creates wealth, a political infrastructure is needed that credibly restricts the power of the state to expropriate entrepreneurial profits and other people's property.

Federalism

A sound political foundation for market processes requires political decentralisation of the authority to determine economic policy, which so far has been best achieved by a federal constitutional order. A federal system of government is one of the institutional configurations most conducive to economic freedom and development (de Tocqueville 1990a). It is a way of minimising the potential for political coercion by injecting the principles of the market into the political structure (Buchanan 1995; 1995/96). The processes of entry, exit and intergovernmental competition that are essential features of federalist structures serve as a constitutional limitation on governmental power. By protecting the autonomy of private decisionmakers, federalism strengthens people's beliefs in their ability to exert power over what happens in their lives, and it raises their general level of attentiveness to market opportunities. 'In a federation economic policy will have to take the form of providing a rational permanent framework within which individual initiative will have the largest possible scope and will be made to work as beneficently as possible' (Hayek 1948; emphasis added). So what exactly is federalism, and what form of federalism is most conducive to a strong sense of agency and heightened entrepreneurial alertness? If the overall objective is to maximise people's entrepreneurial propensity to discover opportunities in the dynamic world in which they live, then it is relatively straightforward to define the ideal of competitive federalism:

4.2.3 Legal decentralisation

In fact, centralized law, like socialism, is not even plausible for a technologically advanced society. The forces that reversed the trend towards socialism and destroyed central planning are also undermining legal centrism. ... As economies become more complex, efficiency demands more decentralized lawmaking, not less. (Cooter 1994: 216)

This section considers different sources of law and alternative institutions of law-making and examines their consequences for human agency and entrepreneurial alertness. It first compares the ideal type of the system of common law (i.e. judge-made law) with that of law-making processes centred on legislation. It then examines customary law as a decentralised process for producing and enforcing legal rules.

The organic common law process versus centralised law-making A relatively decentralised law-making process, such as the common law tradition, which evolves spontaneously and gradually by judicial decisions, is more conducive to the development of a robust sense of personal agency and heightened entrepreneurial alertness than is a centralised legal system codified by the authorities and based on legislation. A decentralised process treats the law as something to be discovered rather than enacted. It is 'both incremental and purposeless. ... The process of legal change is as close to a continuous development as one is likely to see in human affairs' (Rizzo 1985).

The impact of a common law system on personal agency beliefs (and therefore alertness) is shaped by the fact that it corresponds more closely to the ideal of the rule of law. The common law provides a system of abstract and general rules that does not impose a specific hierarchy of ends or values on society and, in this sense, it is 'policy neutral' (Rizzo 1985). It enhances the prospect of a spontaneous market order in which entrepreneurs and other economic actors can effectively pursue their various purposes on the basis of their own knowledge. In other words, the abstract order of the common law promotes economic coordination, and it increases the coincidence of individual expectations and plans (Hayek 1973). Because it offers a greater chance of many economic expectations being correct, the common law process is more likely to make the success of people's planning activities contingent upon their own actions. That is, this legal order is more likely than a centralised law-making process to generate internal LOC beliefs

and alertness. Under a common law system, entrepreneurs are better able to make and fulfill their long-run plans because the overall character of the legal order tends to be highly predictable. The long-run certainty of the common law means that entrepreneurs can enter into commercial relationships with other market participants and enjoy reasonable assurance of the governing rules of law. The power to affect the overall properties of the common law system is widely dispersed among a multitude of judges located at different times and places so that no single judge can do much to alter its overall character. One set of judges can be substituted for another without affecting the general properties of the spontaneous order of the common law. In this sense, common law judges are interchangeable personalities who lack individuality (Leoni 1972). An internal LOC is encouraged as entrepreneurs can expect that the overall pattern of the common law and the legal foundations of their decision-making will not be undermined by 'powerful others'. In addition to the dispersal of power in the legal order, a key institutional source of the certainty and stability of the common law is the rule of precedent, which in the mid-nineteenth century developed into the formal doctrine of stare decisis ('stand by what has been decided previously'). This doctrine refers to the obligation that requires a judge to follow prior applicable precedent even when the judge, in considering the case anew, might have good reasons for reaching a different decision. In practice, the judge may be obliged to adhere to prior decisions of the same court (horizontal stare decisis) and/or to prior decisions of a superior court within the same jurisdiction (vertical stare decisis). The doctrine of stare decisis contributes to an internal LOC because entrepreneurs perceive greater contingency between the legal effects of their actions in the future and legal decisions in the past. It also enhances their sense of self-efficacy because it improves their capacity to predict reasonably accurately how cases that might affect them would be determined in the courts.

The common law doctrine of standing is another institutional rule that strengthens the legal foundation for entrepreneurial discovery and that reinforces entrepreneurs' beliefs in strong personal agency. This traditional judicial doctrine determines who has the right to bring an action in court. In the common law, only the original parties to a contract had the right to go to court in order to enforce the contract or to sue for damages in the event of contractual non-completion. The class of potential plaintiffs granted standing was closed and highly restricted. Third parties – those who were not original parties to the contract – were denied standing to sue even when they might have gained directly from the completion of that contract (Holderness 1985). A restrictive

standing doctrine, such as those in the common law, increases entrepreneurs' sense of control over events. It enhances their capacity to adjust their individual plans in the event of unexpected economic changes. If an entrepreneur discovers a change in economic conditions that makes it no longer profitable for him or her to execute a contract that he or she has already entered into, all the entrepreneur has to do is to settle the amount of damages for the breach and negotiate new terms (such as a later date of delivery for a new product) with the person who paid his or her consideration. Restrictive standing means that the entrepreneur does not have to go about identifying and negotiating with numerous third parties who were not original parties to the contract but would benefit from the performance of the contract as written. A restricted standing doctrine thereby reduces the transaction costs that entrepreneurs incur in revising their plans in the light of new knowledge, and it increases their flexibility in coping with change. Restrictive standing also facilitates market processes and economic coordination by increasing the transferability of property rights. It enables entrepreneurs to reallocate resources from their current uses to the highervalued uses that they discover. In addition, a restrictive standing doctrine secures economic freedom by reducing the threat of third-party interference in the right to exercise ownership in private property.

Customary law

Customary rules are another source of law. A customary legal system is a spontaneous and highly decentralised process of law-making that has consequences for human agency and entrepreneurial alertness that are in some respects similar to those of the common law. Customs are norms that emerge spontaneously outside the state's machinery for producing law. They are more than just behavioural regularities; they are internalised obligations or 'felt norms' that direct behaviour of members of a group (Cooter 1993). A behavioural pattern that many people do not regard as socially necessary (e.g. shaking hands upon making someone's acquaintance) does not constitute a binding custom. In addition, in order to become a customary legal rule, a behavioural practice must receive widespread recognition and acceptance from members of the relevant social group (Pospisil 1971). Reciprocities and the recognition of mutual benefits from cooperation play an important role in the formation of customs. There are many historical examples of customary legal systems but the most impressive is medieval commercial law or the Law Merchant (*lexmercatoria*). This law was a dynamic system of evolving legal rules that was

customarily produced, privately adjudicated and privately enforced. The medieval Law Merchant illustrates how the role reversibility of merchants (who are buyers one day, sellers the next) induced them to adopt mutually desirable rules that benefited them all. Customary medieval commercial law was subsequently absorbed into the common law. Its modern-day counterpart is the 'new' Law Merchant, which includes private international commercial law and the customary rules of international trade relating to negotiation, mediation and arbitration.

4.2.4 Freedom of entrepreneurial choice and concrete liberties

The standard conception of choice in economic theory identifies individual freedom with the power to achieve given goals. In mainstream economics, the ends between which the agent can select and the criteria of selection are given, as are the means to achieve each end. Freedom of choice in such circumstances is empty (Shackle 1969). Individuals are denied the freedom to choose ends and means: they are not free to decide what to do or how to do it. Their freedom is limited to economising in the allocation of given means to achieve a set of given ends. Moreover, in the world of mainstream economic models, the optimal course of action is determined uniquely by objective situational characteristics, such as costs, prices, consumer preferences and technology (Latsis 1972). The solution is implicit in the definition of the maximisation problem. 'Any other decision would have been unthinkable' (Kirzner 1982c). This notion of freedom turns out to involve no choice at all: 'One has, in this conception of choice, in effect already chosen before the moment of decision' (Kirzner 1979). Such a restrictive view of freedom is totally inadequate as a basis for entrepreneurship and for explaining the role of freedom in the workings of the market economy. Apart from confusing freedom with power, this view of freedom precludes entrepreneurship in the sense of alertness to opportunities and the discovery and creation of new ends–means frameworks. The freedom of entrepreneurial choice is a 'meta-freedom' in the sense that it applies to all the other freedoms, which relate to some or other aspect of choice. Kirzner has been the first to elaborate in detail this important perspective on freedom, though it clearly derives from the Misesian conception of human action. This broader perspective grants entrepreneurs far more than just the freedom to implement the optimum solution implied in some automatically known or given problem situation:

Freedom of choice can now be seen to encompass the liberty to make up one's own mind as to the ranking of ends to be pursued and the means judged available for the purpose. Once a given

ends–means framework has been adopted, freedom can only mean the freedom to achieve what one has already announced that one wishes to achieve. It is this narrow view of freedom that many economists seem to have adopted. But, with the acting man seen as approaching choice without having firmly adopted any one framework of ends and means, freedom of choice is at once seen as freedom to announce (i.e., to choose) what it is one wishes to achieve. ... The wider view of freedom recognizes that, when people refer to the freedom to choose, they have in mind liberty to select among a wide range of moral and value frameworks, of ethical systems, of tastes; to make their own guesses concerning present realities and future uncertainties; to determine for themselves what opportunities they are in fact confronted with (Kirzner 1979).

The entrepreneurial view of liberty emphasises how freedom of choice may evoke the discovery of opportunities that would be unthinkable to those to whom this freedom is denied. It stresses the open-endedness of an unimpeded market process. It also serves to warn us that the biggest perils arising from limiting freedom of entrepreneurial choice are likely to be hidden. As a general rule, individuals and groups cannot know what welfare losses have been suffered as a result of reducing entrepreneurial freedom, since no one can know what they (or the market) might have discovered in the absence of the constraint. Kirzner (1985) applies this important insight to examining the costs of regulating economic activity. The law ‘transmutes’ the general principle of freedom into concrete liberties or rights. ‘By means of this transmutation, the law economizes intangible freedom into tangible properties’ (Dietze 1976). In any particular society, the principle of freedom may or may not be applied to many kinds of human activity. The definition of liberty and our knowledge of it are open ended. Over time, entrepreneurs and other market participants may discover and exercise liberties that have not yet been dreamed of:

It also follows that the importance of our being free to do a particular thing has nothing to do with the question of whether we or the majority are ever likely to make use of that particular possibility. To grant no more freedom than all can exercise would be to misconceive its function completely. The freedom that will be used by only one man in a million may be more important to society and more beneficial to the majority than any freedom that we will all use. It might even be said that the less likely the opportunity to make use of freedom to do a particular thing, the more precious it will be for society as a whole. The less likely the opportunity, the more serious will it be to miss it when it arises, for the experience that it offers will be nearly unique.

... It is because we do not know how individuals will use their freedom that it is important.
(Hayek 1960)

Table 5.1 A catalogue of economic freedoms important to entrepreneurship

<i>Freedom of</i>	<i>would mean that economic actors, including entrepreneurs, are free to:</i>
Choice of ownership form	choose the ownership form (limited liability company etc.) most appropriate to the individual circumstances of their ventures
Coalition and association	network with other entrepreneurs and economic actors and combine with anybody for any purpose not interfering with the freedom of others
Privacy and secrecy	develop and communicate their novel ideas without the oversight of any unwelcome party keep their entrepreneurial hunches and knowledge secret
Expression and speech	speak privately and publicly, to express their novel ideas in any tangible form (such as a business plan or prototype) and to print and publish on any subject whatsoever
Non-conformance	be different in behaviour, habits and business practices
Experimentation	try something new, to commission R&D in any field (including marketing research), to test their ideas, to make mistakes and fail, and to bear the consequences of their own errors
Search	investigate and acquire information on any subject by any method, except with use of violence, theft or fraud
Choice of consumption	purchase any goods or services that they choose to satisfy their current wants
Revision	change their plans and decisions made in the course of exercising any of the freedoms in this list (e.g. to revise their choices of occupation or of marketing)

Entrepreneurial choice	<p>make their own discoveries, to discover and exploit perceived profit opportunities through arbitrage, speculation and innovation, 'to identify for themselves what the opportunities are which they may endeavor to grasp' (Kirzner 1992: 53)</p> <p>attempt to coordinate any transactions in any market in any place in any time period</p> <p>attempt to coordinate any kind of resources for any kind of venture in any industry or market</p>
Achievement of rewards	<p>'seize benefit for themselves from the opportunities they have discovered' (Kirzner 1992: 54), to make profits, to appropriate the rewards of arbitrage, speculation and innovation</p>
Trade	<p>import or export any kind, quantity and quality of goods and services</p> <p>discover and exploit domestic and international price differentials for the 'same' commodities</p> <p>adjust prices, quantities and qualities bid or offered in response to new market conditions</p>
Markets	<p>buy or sell any quantity and quality at any mutually agreed price</p>
Contract	<p>pursue their interests through voluntarily making binding promises, however prudent or imprudent, with any other individual, group or organisation</p>
Competition, entry and exit	<p>enter (or exit from) any market or industry and compete as best they can, provided that they do not interfere with the freedom of others</p> <p>displace existing organisations and industries that fail to adapt to their environment</p>

Choice of production	adjust the bundle of inputs and methods of production in order to exploit profit opportunities arising from imperfect coordination between factor and product markets choose a suitable location when starting a venture
Choice of marketing	promote, advertise and distribute anything in any way
Choice of occupation	enter the occupation of their choice, to become an entrepreneur, trader or a business person rather than to work in some other kind of occupation, and not to work at all
Movement	travel according to their own choice (within and across national boundaries), to make their residence anywhere they choose and to hire employees from other countries
Ownership	own and acquire property

Freedom of would mean that economic actors, including entrepreneurs, are free to:

Entrepreneurial choice make their own discoveries, to discover and exploit perceived profit opportunities through arbitrage, speculation and innovation, ‘to identify for themselves what the opportunities are which they may endeavor to grasp’ (Kirzner 1992) attempt to coordinate any transactions in any market in any place in any time period attempt to coordinate any kind of resources for any kind of venture in any industry or market Achievement of rewards ‘seize benefit for themselves from the opportunities they have discovered’ (Kirzner 1992), to make profits, to appropriate the rewards of arbitrage, speculation and innovation Trade import or export any kind, quantity and quality of goods and services discover and exploit domestic and international price differentials for the ‘same’ commodities adjust prices, quantities and qualities bid or offered in response to new market conditions Markets buy or sell any quantity and quality at any mutually agreed price Contract pursue their interests through voluntarily making binding promises, however prudent or imprudent, with any other individual, group or organisation Competition, entry and exit enter (or exit from) any market or industry and compete as best they can, provided that they do not interfere with the freedom of others displace existing organisations and industries that fail to adapt to their environment Choice of production adjust the bundle of inputs and methods of production in order to exploit profit opportunities arising from imperfect coordination between factor and product markets choose a suitable location when starting a venture Choice of marketing promote, advertise and distribute anything in any way Choice of occupation enter the occupation of their choice, to become an entrepreneur, trader or a business person rather than to work in some other kind of occupation, and not to work at all Movement travel according to their own choice (within and across national boundaries), to

make their residence anywhere they choose and to hire employees from other countries. Ownership: own and acquire property more of one may allow either more or less of another. Thus, a greater degree of liberty in one sphere of human activity may make it either easier or harder to achieve freedom in another sphere (Machlup 1969).

4.2.5 Empirical studies on economic freedom and economic performance

Unfortunately, there are as yet no empirical studies that directly investigate the impact of economic freedom on people's cognitions and entrepreneurial alertness. However, if we accept that entrepreneurship is the main driver of economic growth and development, then we might be able to change their plans and decisions made in the course of exercising any of the freedoms in this list (e.g. to revise their choices of occupation or of marketing). Source: Table is significantly adapted and expanded from Machlup (1969) gain insights indirectly from empirical research on the relationship between economic freedom and economic performance.

Unfortunately, empirical analysis in this area is bedevilled by problems that frustrate attempts to test hypotheses about the interplay between economic freedom and growth. The first significant problem has been the absence of a precise operational definition of economic freedom and a lack of a clear specification of the crucial components of economic liberty. This makes it difficult to classify particular countries according to the degree of government intervention in the economy. Economic freedom is a subtle and elusive concept. It represents a highly complex, multi-dimensional aspect of a country's institutions. The second set of problems is concerned with how to measure economic freedom and in particular how to quantify and weigh the components of economic liberty. Because economic freedom is not one dimensional, no single statistic can fully reflect its many features. Thus, economic freedom cannot be captured merely by measuring the size of the state in a nation – typically measured as total government expenditures as a percentage of GDP. Instead, it is necessary to compare alternative forms of government involvement in the economy, and to assess how they change the economic incentives that individuals face and how they might violate economic freedom.¹³ Moreover, the level of economic freedom in nations can at best only be ranked in ordinal terms; it is not amenable to cardinal (absolute) measurement in terms of some unit or other. In other words, it might be possible to order countries by their degree of economic freedom but it is not possible to say by how much freedom differs between one nation and the next nation in the ranking. There is also a

lack of readily available data on the relevant components of economic freedom for a broad cross-section of countries and over a sufficiently long time span. Many dimensions of economic freedom are inherently difficult to quantify objectively across a large number of countries. For example, regulatory interventions are often complex, and their application is often subtle and idiosyncratic to a country, which makes it extremely difficult to quantify the effects of regulation objectively. Because data on many attributes of economic freedom are not available, it is often necessary to use various proxies for these attributes. ‘These proxies may mirror the underlying element of liberty with some distortion’ (Hanke and Walters 1997). The next problem is how to combine various components of economic freedom into a single summary measure for each nation. The problem is how to weight the components in order to construct aggregate indices of economic freedom. Different weighting techniques might yield different relative rankings of countries by their degree of economic freedom (Caudill et al. 2000; Scully and Slottje 1991). Similarly, the robustness of the statistical relationship between economic freedom and the growth rate of real per capita GDP depends crucially upon how freedom is measured (De Haan and Sierman 1998). Another problem arises in connection with the protracted and variable time lags involved. How long will it take for the changes in public policy that impinge on economic freedom to affect the growth rate of output? ‘The advantages that freedom brings are shown only by the lapse of time, and it is always easy to mistake the cause in which they originate’ (de Tocqueville 1990b). The time lag occurs because credibility in public policy is not immediate but must be secured over time, and the time period required depends upon historical factors and current political conditions (such as previous political instability and the strength of political opposition to policy initiatives already implemented). These time lags will weaken the empirical relationship between growth and changes in economic freedom in the short run. Thus, we need data for relatively long periods of time in order to test for a potential relationship between economic growth and economic freedom (both level and change).

Chapter Five - Culture and alertness

Entrepreneurship necessarily takes place within culture, it is utterly shaped by culture, and it fundamentally consists in interpreting and influencing culture. Consequently, the social scientist can understand it only if he is willing to immerse himself in the cultural context in which the entrepreneurial process occurs (Lavoie 1991).

5.1 The entrepreneurial power of individualism, and cultural convergence

Investigations of culture and entrepreneurship commonly assume or argue that individualism and economic development (itself an entrepreneurially driven process) are intrinsically and ineluctably related to one another. This idea can be decomposed into two additional theses that may or may not be made explicit in any particular study:

1 Individualism is more conducive to (or, more strongly, is a necessary condition for) entrepreneurship and economic development in a modern economy. Consequently, individualist cultures and nations are more entrepreneurial than group-oriented ones.

2 As societies modernise and industrialise, the cultural values of their members tend to converge towards individualism. The process of modernisation dissolves group-oriented communities and cultures, and it promotes individualist values.

The first thesis, hereafter referred to as the cornerstone hypothesis, presents individualism as an antecedent to entrepreneurship and economic development. In contrast, the second thesis, the convergence hypothesis, presents individualism as a consequence of economic and other social processes through which societies develop and modernise.

The cornerstone hypothesis

The distinctive individualism of Western culture can be argued to have provided a climate that was very congenial to the emergence of modern entrepreneurship and industrial capitalism. That individualism is a crucial element in modernisation¹ has, of course, been a conventional theme ever since Weber's seminal work. Weber (1930) argued that the Protestant emphasis on the enhancement of individuals and the rational pursuit of economic gain was a main source of rapid Western economic development. In particular, the Calvinist notion of demonstrating one's faith

through the performance of good works in worldly activity spurred individuals to choose business as an occupation, thereby releasing and channelling their entrepreneurial energies and increasing entrepreneurial supply. According to at least one interpretation, Weber argued that the Protestant ethic² provided a necessary though not sufficient condition for the emergence of modern capitalism (Berger 1991b). Hayek (1979) too seems to argue that modernisation requires Westernisation and that the market economy requires a cultural substratum comprising individualist rules of conduct. In addition, the belief that individualist cultures are more entrepreneurial than group-oriented ones is a 'cornerstone of entrepreneurship theory and research' in the organisational sciences (Tiessen 1997). For example, Shane (1993) tested the hypothesis that individualist societies are more innovative than group-oriented societies. Having controlled for national differences in industrial structure and per capita income, he found that national rates of innovation (as measured by per capita numbers of trademarks granted in the US market and world markets) were significantly associated with Hofstede's (1980) index of individualism in 1975 but not in 1980. He concludes that 'the positive relationship between innovation and individualism suggests that the possession of the beliefs that individualism represents – autonomy, independence and freedom – make some countries more innovative than others'. In his review of firm-level studies, Tiessen reports that international research into the founders of business start-ups also shows a strong association between individualism and entrepreneurship. In general, entrepreneurs in this line of enquiry are narrowly defined as individuals who start a stand-alone business. For instance, in their cross-cultural study of value differences between entrepreneurs and non-entrepreneurs in eight (mostly Western) countries, McGrath et al. (1992a) reported that 'in a number of quite different societies, entrepreneurship is associated with high individualism'. They found support for the thesis that entrepreneurs (business founders) generally hold individualist values when compared with non-entrepreneurs, so that 'entrepreneurs favor independent action and separation from groups and clans', no matter what the cultural orientation of the broader society. Similar results were reported by Holt (1997) and McGrath and MacMillan (1992). In fact, Holt suggests that if the similarity between the value systems of mainland Chinese entrepreneurs and of US entrepreneurs reflects changes occurring in China's transition, then 'it is possible that convergence is beginning to occur, although on a parsimonious scale'. This brings us to the second hypothesis for consideration, the convergence hypothesis.

The convergence hypothesis

The convergence hypothesis relates to the dynamics of cultural change. It assumes that, with sufficient diffusion of technology and the appropriate introduction of other resources, all societies will go through a similar growth process and will come to share characteristics (including cultural values and patterns of social relatedness) that are typical of modern societies in Western Europe and North America. 'Modernization, then, in the essentialist view of evolution, was seen as a convergent process wherein all societies as they developed were assumed to become more alike' (Greenfield and Strickon 1981). All societies are expected to have a common destination, regardless of the uniqueness of their cultural origins. Hayek (1979; 1988) too explained the emergence of individualism within an evolutionary framework. Although Hayek (1976) accepts that many societies exist which subscribe to very different systems of rules, he suggests that the general and abstract rules of conduct in individualist society tend to prevail over the practices of the 'tribal' or 'small-group' society, which he sees as encompassing aggressiveness towards strangers, within-group solidarity and striving towards common concrete goals. According to Hayek, the latter values evolved very early on in humanity's cultural history. Individualist norms and precepts have displaced many small-group values and have spread throughout Western civilisation because the groups that adopted individualist values prospered more than other groups and grew:

Some economists, most notably Hayek, have seen the importance of the cultural correlates of a market economy as an important element in its functioning, with Hayek even arguing for a form of cultural evolution that has in an unplanned and unintended way led to a move from a Stone Age culture, with its sense of community and shared purpose, to a modern culture where there is respect for abstract rules, such as the rule of law, and 'a detachment from communal cooperative ends'. (Lal 1998)

Past critique of received view

The convergence hypothesis has been subject to strong criticism. Critics argue that processes of economic development and modernisation in different countries are unique, diverse and open-ended. Socio-cultural change is not assumed to be directional or convergent. The position is well summarised by Abraham:

The theory of convergence, or what Lauer calls the fallacy of unidirectionality, which postulates that the end product of modernization in developing countries is the Western type 'modern' industrialized society, not only rests on false premises but also draws dangerously erroneous conclusions. ... The experience of Japan, which modernized itself while maintaining and utilizing premodern traditional institutions ... not only questions the notion of the antithesis between tradition and modernity ... but also rejects the unilinear assumption underlying various models of modernization. (Abraham 1980)

Thus, the belief that the relationship between individualism and entrepreneurial capitalism (or, more generally, modernity) is universal has been challenged in recent decades by the development path of Japan, as Abraham observes, as well as the track records of several other East Asian nations, namely, the 'four little tigers': Taiwan, South Korea, Hong Kong and Singapore. During the second half of the twentieth century, these economies achieved spectacular economic success in world markets and became a major force in international trade, industrial and textile production, banking and technological development. Making a success of entrepreneurial capitalism in the modern global economy does not, it seems, require economies to converge towards a specific set of cultural values. Capitalism permits differences in cultural traits and patterns of behaviour to endure. Indeed, the blossoming of an entrepreneurial drive in these East Asian societies is sometimes explained as having occurred because of, rather than in spite of, some aspect of their group-oriented cultures, whether it be the key tenets of Confucianism, East Asian Buddhism or Chinese folk religion. Studies refer to the 'entrepreneurial power' of Confucian values and practices (Harrison 1992), 'entrepreneurial familism' (Wong 1985) and the future-oriented, economically dynamic mindset of 'Confucian work dynamism' (Chinese Culture Connection 1987). Moreover, the industrialisation of these societies has not led to a convergence towards individualism across all domains. 'The "Five Tigers" were adopting and modifying the technological knowledge of the West, but were not forgetting their traditional [cultural] psychologies. Change was encouraged and promoted, but the cultural psyche was not sacrificed' (Marsella and Choi 1993). The focus in these societies is still upon the family, clan, work group, firm, school or other in-group. They still prize a group orientation rather than individuality. In Japan, for instance, people have in general retained a non-individualist, interdependent conception of self as their economy and society have undergone dramatic transformation (Yamaguchi 1994): 'Thus the Japanese have been able to

adjust to the needs of modernization without westernizing their selves' (Lal 1998; emphasis added). Similarly, a survey study of two generations of South Koreans has shown that, in spite of changes towards individualism in some domains, the great majority of Korean adults, whether young or old, endorse group-oriented values, such as the acceptance of relational obligations and in-group favouritism (e.g. preferential treatment of school alumni) (Cha 1994). They remained 'largely collectivist rather than individualist in absolute terms'. Ho and Chiu (1994) report a similar overall result for Hong Kong university students. More generally, Peter Berger makes a similar observation about the constancy of group-oriented values in East Asia:

It can plausibly be argued that East Asia, even in its most modernized sectors, continues to adhere to values of collective solidarity and discipline that strike the Western observer as very different indeed from his accustomed values and patterns of conduct. ... Could it be that East Asia has successfully generated a non-individualistic version of capitalist modernity? If so, the linkage between modernity, capitalism and individualism has not been inevitable or intrinsic; rather it would have to be reinterpreted as the outcome of contingent historical circumstances. (Berger 1988; emphasis added)

Although the crises of the Asian economies in the late 1990s highlighted severe weaknesses in their legal and financial systems and the nature of business–government relations, these events still do not undermine the fact that processes of entrepreneurship and economic development in industrial societies can assume cultural forms quite different from that in the West.

Asia will continue to modernize and, in doing so, will produce forms and practices that are distinctive. ... Cultural differences will endure, and in most cases there is little point in trying to say which cultures are superior and which ones inferior. (Pye 2000; emphasis added)

The convergence thesis is also brought into question by empirical entrepreneurship research in the organisational sciences. McGrath et al. (1992b) undertook a cross-cultural study comparing the values of entrepreneurs (defined as new business founders) from the People's Republic of China, Taiwan and the USA. They found that the two groups of Chinese entrepreneurs continue to share a group-oriented perspective for six of the eight discriminating items related to individualism–collectivism. In none of the items related to individualism did the Taiwanese

entrepreneurs score significantly closer to the US sample than to the mainland Chinese sample of entrepreneurs.

Our interpretation is therefore that along the individualism/collectivism dimension of culture, collectivist values are generally highly enduring – 50 years of exposure to very different ideologies [i.e. political, economic and social interventions] has done little to break down the The approach in this chapter The theory developed here is a preliminary step towards an account of why and how different cultures might promote a high degree of alertness and why significant cultural diversity can be expected to persist even among advanced capitalist societies. More specifically, and in contrast to the cornerstone and convergence hypotheses, the approach in this chapter explains why we can expect a subset of group-oriented cultures to be highly entrepreneurial and why we do not expect all market-based economies to converge on a single dominant pattern of individualist values. ‘There is no inexorable convergence of countries towards greater individualism in values with the march of time and progress’ (Smith and Bond 1993). The approach acknowledges the possibility of ‘multiple adaptive peaks’ in evolutionary processes (Gould and Lewontin 1994) – that is, it recognises that cultures can develop along different evolutionary paths to that of Western civilisation and still survive and prosper. In the language of Freeman (2000), the approach emphasises ‘diversified’ rather than ‘single-peaked’ capitalism. The underlying premise is that divergent cultures that we observe in the world today would not have survived to this point if they were absolutely lacking in entrepreneurship and adaptability to changes in economic conditions. ‘Casual empiricism reveals a wide degree of cultural variety consistent with the survival of a group in the modern world’ (Vaughn 1984). The observation that economic development and modernisation may assume significantly different cultural forms raises the question: could it be that a society’s path towards economic prosperity depends at least in part on entrepreneurs discovering and exploiting those aspects of its culture(s) that constitute its comparative cultural advantages (given the institutional and situational context)? Following Lavoie and Chamlee-Wright (2000), this chapter takes the view that each society has cultural characteristics particular to its own circumstances that might influence how entrepreneurship is manifested and how markets are coordinated and that might therefore promote different patterns of economic development. Each society can prosper economically by taking advantage of its own cultural traditions and heritage. Just as two countries with a comparative advantage in two different products can trade those products to their mutual benefit,

so too can each country benefit from focusing on those entrepreneurial activities in which its culture gives it relative strengths (Berger 1988). ‘Comparative advantage is a story of diversity; of gains that come from differing from one’s neighbor, not from aping him’ (Freeman 2000; emphasis added).

Accordingly, the approach adopted here suggests that we need to reject the notion that individualism or communalism (i.e. group orientation, collectivism) per se is either categorically pro- or anti-entrepreneurship. That is, we need to acknowledge that the cornerstone hypothesis can lead us badly astray. Individualist and group-oriented cultures neither inherently promote nor inhibit processes of entrepreneurial discovery. The distinctive individualism generated in the West is neither a necessary nor a sufficient condition for the emergence of entrepreneurial alertness. More generally, there is no universal, contextually independent scale by which one can assess and rank the dominant culture of an entire nation in terms of its ‘entrepreneurial content’ or ‘growth-friendliness’, as do Casson (1990) and Harrison (1992): ‘It is unscientific to try to draw up a universal list of positive and negative cultural values for economic development. What may be positive in some circumstances can be quite counterproductive under other conditions’ (Pye 2000). Lavoie and Chamlee-Wright (2000) refer pejoratively to such exercises in scoring national cultures according to their entrepreneurial content as ‘checklist ethnography’. This chapter focuses upon just one, though crucial, aspect of the complex phenomenon of culture – namely, different construals of selfhood – and how they affect the supply of entrepreneurial alertness. The analysis distinguishes between two notions, the independent and interdependent self, and it examines the key differences between them. The independent self represents how people in an individualist cultural group typically define themselves. The interdependent self is the corresponding conception for group-oriented cultures. This distinction is considered to be one of the most important and deeply rooted sources of cultural variation. Cultural self-conceptions are culturally evolved rules that are of a very general and basic nature. The specifics of any particular culture’s comparative advantages will depend, at least partially, upon the conception of self that is most prevalent in that culture.

5.1.1 The impact of cultural self-conceptions on psychological determinants of alertness

An important mechanism by which cultural self-conceptions influence entrepreneurial alertness is through their effects on people’s cognitive processes. More specifically, how personhood is

construed in a particular culture affects the structure, content and possibly the intensity of people's agency beliefs. It explained how these beliefs are an amalgam of perceptions of locus of control (LOC) and self-efficacy. That is, one's subjective perceptions of personal agency combine two sets of expectations: (i) LOC beliefs about whether actions influence outcomes; and (ii) self-efficacy beliefs about whether one can produce the relevant actions. Cultural differences in self-conceptions might lead individuals in one group or society to think of agency as primarily about changing the environment to fit the self's needs, while people in another group or society might view agency as mainly about changing themselves to fit their environment. In addition, the chapter examines how independent and interdependent self-conceptions affect the meaning and sources of internal control within a culture.

5.1.2 The impact of cultural self-conceptions upon the unit and character of alertness

As explained later, the two notions of selfhood also influence how entrepreneurship is manifested and the nature of the opportunities that entrepreneurs discover. They determine in part the different channels through which entrepreneurship is likely to proceed in different societies. In particular, they determine the most prevalent unit or locus of alertness within a cultural group: 'The typical entrepreneur will reflect the specific cultural context out of which he or she emerges' (Lavoie and Chamlee Wright 2000). The notion of selfhood dominant in a culture determines the definition, structure, boundaries and character of the entity that does the perceiving and discovering of profit opportunities in that culture. In an individualist culture, the most common unit of alertness is the independent, autonomous person. In contrast, the primary centres of alertness in a group-oriented culture are interdependent members of an in-group. These two units of alertness are different units of analysis: they are different entities, they behave according to different rules, and their 'mental models' differ. Cultural construals of the self- give form and direction to people's alertness and entrepreneurial potential:

Entrepreneurship is not only a matter of opening one's eyes, of switching on one's attentiveness; it requires directing one's gaze. ... And this raises the question of what gives pre-directedness to the entrepreneur's vision, of why he is apt to read some things and not others.

Cultural differences in the degree of people's autonomy and social embeddedness affect the character of alertness to opportunities. In individualist cultural groups, independent selves are

alert to opportunities that are relevant to direct, personal gain. Their alertness is solely self-referential. In addition, alertness is commonly manifested in individual entrepreneurship. Independent selves have a tendency to be more alert to entrepreneurial opportunities for litigation, opportunities for the application of new commitment devices that reduce principal–agent problems, and opportunities requiring a nexus of formal, legal arrangements or contracts. In communalist cultural groups, the alertness of interdependent selves is multi-layered and multi-dimensional. Their alertness has both role-referential and group-referential aspects. Interdependent selves each exhibit alertness to opportunities relevant to the successful fulfilment of their own roles in the group (‘micro-alertness’). They may also exhibit alertness to profitable opportunities for collective action by the in-group as a whole (‘macroalertness’). The alertness of interdependent selves is manifested in collective or corporate entrepreneurship. Group-oriented entrepreneurs are likely to be more alert to opportunities for leveraging resources through informal networks and to be more vigilant of opportunities requiring consensus decisionmaking and teamwork. They are likely to be more alert to opportunities for non-legal conflict resolution.

5.2 Variation in cultural conceptions of the self

5.2.1 Defining culture

In line with recent thinking in cultural anthropology and psychology, I place little emphasis on ‘material’ culture and its external manifestations, such as inherited artefacts. Instead, I focus upon ‘subjective’ or ‘mental’ culture – the ‘software of the mind’, to use Hofstede’s (1991) evocative phrase. Cultural and social phenomena are largely mental phenomena: ‘without the contact of mind with mind, they would not exist’ (Davis 1948). For the purpose of studying the cultural context of entrepreneurship, I choose to adopt a contemporary social science definition of culture as ‘a complex system of shared symbols that expresses and that regulates codes of conduct that sustain particular forms of human sociality’ (McGavin 1993). I maintain that the essential core of culture consists in the underlying values, moral principles, beliefs, norms, roles and cognitive styles that are shared to some degree by members of a human social group. The fundamental value priorities prevalent in a society are at the very heart of culture and have a major impact upon entrepreneurship. Values (in the form of both moral prohibitions and ideals) pervade an individual’s overall conception of self: ‘Cultural traditions ... regulate ... the human psyche, resulting in ethnic divergences in mind, self and emotion’ (Shweder 1990). How one

conceives oneself and one's relationship to others is intimately tied to the values and ethics of one's own cultural group. Culture is a 'packaged variable' (Whiting 1976). It must be unbundled if we are to use it as an explanatory construct in our analyses of entrepreneurship and in our critical appraisal of the cornerstone and convergence hypotheses. The approach here unbundles and operationalises the concept of culture by focusing on higher-order dimensions of values that are appropriate for comparing cultures. In particular, this chapter takes individualism–collectivism (I/C) to be the most critical high-order dimension for understanding differences in entrepreneurship across diverse cultures around the world. Individualist values emphasise giving priority to personal goals, independence, personal achievement and competition. Collectivist (i.e. group-oriented) values stress giving priority to group interests, interdependence, group achievement and cooperation with other in-group members (Triandis 1995). The I/C dimension has so far proven to be the most coherent, integrated and empirically testable dimension of cultural variation in values (Kim et al. 1994b: 2). However, the I/C continuum is a very broad dimension that can be defined more precisely in terms of more specific types of values. Most significantly for present purposes, the central feature of the I/C dimension pertains to the issue of the independence (autonomy) vs. interdependence (embeddedness) of the person vis-à-vis the group. Thus, at a fundamental level, individualist and group-oriented cultural values reflect how people in a particular cultural setting define themselves and how they experience their personhood:

A major theme of the I/C dimension concerns thinking about or construing the self as an independent entity motivated by personal standards or as an interdependent part of social groups motivated by social expectations. (Smith and Schwartz 1997)

In essence, the I/C dimension reflects people's views on whether they see themselves as independent, bounded, autonomous individuals, or as inter dependent persons who are inseparable from their social relationships. In psychological lingo, these two views are referred to as the independent and interdependent conceptions of the self, and these constructs are taken to be the most significant source of cultural differences.

5.2.2 The self as a cultural artefact

The conception of self is a crucial element of a cultural group's 'subjective culture' (to the extent that it is shared by members of that group) (Triandis 1972). It reflects the shared understanding of what it means to be human. The self-concept is not just influenced by culture; it is deeply culturally constructed. Self-conceptions are highly symbolic constructions that are artefacts of the cultural system of symbolic meaning. Developments in cultural psychology suggest that our construal of self is a social construction generated by our active participation in the practices and shared meanings (including values and norms) of particular cultural contexts. It is influenced and constrained by the patterns of social interaction with parents, peers, teachers, and so forth, that are characteristic of a particular culture. There is no such thing as a human nature independent of culture (Geertz 1973). Without culture, there is no person or self, there is only a biological entity. Hayek (1979) made a similar point in his analysis of the concurrent evolution of mind and culture: without mind, no civilisation; but equally significantly, no mind without civilisation. Self-conceptions are an integral part of personality. They affect how we construe the qualities and attributes of being a person. They underpin our social identity and influence how we act and handle different situations in the social and economic sphere. Cultural groups differ in their conceptions of selfhood and have divergent views of the relationship between 'the self' and 'others'. By emphasising individual autonomy or interpersonal connectedness, a culture both expresses and regulates how people in a society construe themselves and it can thereby potentially affect cognitive functioning, including alertness to opportunity.

5.2.3 The independent self

As mentioned already, empirical research in cross-cultural psychology and anthropology draws the distinction between two cultural conceptions of selfhood: the independent and interdependent self. Table 5.1 summarises the key differences between these two ways of thinking about the self that are found in different cultural groups.

Table 0.1 Key differences between cultural conceptions of the independent and interdependent self

<i>Feature</i>	<i>Independent conception of self</i>	<i>Interdependent conception of self</i>
Definition of the self	<p>The person is an autonomous entity, existing independently of society</p> <p>A person's identity is not rooted in, or bounded by, social context or group membership</p> <p>Weak dependency of each individual on any specific group</p> <p>Clear, strong boundaries between the self and others</p> <p>Knowledge of inner self is more detailed than knowledge about other people (Greenwald and Pratkanis 1984)</p>	<p>The person is an inseparable part of a larger social whole</p> <p>The characteristics of one's clan or social group are an integral part of one's personal identity</p> <p>Strong dependency of each person on his or her in-group</p> <p>Fluid, augmented boundaries – relationships with close in-group members included in boundaries of the self</p> <p>Knowledge of inner self is less elaborated than knowledge of other in-group members and the self's relationship to them (Markus and Kitayama 1991)</p>
Perceptual and cognitive focus of the self	<p>Perceptions focus on individuals; relationships and groups are in the background</p> <p>Egocentrism</p> <p>The individual is the unit of analysis in both the evaluation of ends and the selection of means</p> <p>Personal goals have priority and often conflict with group goals</p> <p>Cognitions are context independent</p> <p>Cognitions focus upon inner, private thoughts, feelings, attitudes, personal needs and abilities</p>	<p>Perceptions focus on relationships and groups; individuals are in the background (Triandis 1994a: 167)</p> <p>Socio-centricism or in-group egoism (rather than altruism)</p> <p>Ends are evaluated and means chosen on the basis of their consequences for the in-group and the fulfilment of one's social role</p> <p>In-group goals have priority or overlap personal goals</p> <p>Cognitions are context dependent (Triandis 1994b: 47)</p> <p>Cognitions focus upon the self in relation to specific others, social roles, relationships, statuses, norms, obligations, duties and the needs of the in-group</p>

<i>Feature</i>	<i>Independent conception of self</i>	<i>Interdependent conception of self</i>
	Explanations of individual behaviour focus upon the actor's general dispositions, traits and inner attributes (Miller 1984)	Explanations of individual behaviour focus upon the actor's social role and interpersonal relationships
Stability and consistency of the self	Personality and individual behaviour are supposed to be stable over time and across different situations	Personality and individual behaviour are supposed to vary over time and across different situations
Cultural values	Autonomy; freedom of individual thought, feeling and action; mastery over nature; assertiveness; ambition; creativity; stimulating activity; self-reliance; separation from family and community; individual achievement; and material success (Bellah <i>et al.</i> 1996; Schwartz 1994)	Dynamic orientation towards the future, perseverance in obtaining long-term goals, group achievement, harmony in interpersonal relations, respect for tradition, modesty, reciprocity of favours, and unity with nature (Chinese Culture Connection 1987; Hofstede 1991; Schwartz 1994)
Rights conception	Individuals are endowed with independent legal, moral and religious rights Rights are ascribed to individuals, apart from and prior to their entering into social relationships Rights are primarily rights <i>against</i> others in the society and the threats they present	Rights are more likely to adhere to various social entities or positions Rights are subordinate elements of more basic norms governing social relationships and are ascribed to social roles and relationships rather than individuals Rights are primarily rights held because of one's <i>connection with</i> others in associational webs of the society
Culturally mandated tasks of the self	Be unique, express oneself, promote one's own goals, develop one's potential	Belong, restrain oneself, occupy and fulfil one's proper role within the in-group, promote in-group's goals (Markus and Kitayama 1991)
Exemplary cultures	Anglo-American, Anglo-Celtic, Australian, English, Dutch, New Zealand European, Swedish, French	Japanese, Han Chinese, Korean, Taiwanese, Thai, Balinese, Malay, Samoan, Maori (New Zealand), Greek, Turkish, Berber (Morocco), Yoruban (Nigeria), Akan (Ghana), Kikuyu (Kenya)

The first conception of the self sees the individual as a 'self-contained, individuated, separated, independent self -defined by clear boundaries from others' (Kagitçibasi 1997). The person is a 'bounded, coherent, stable, autonomous, free entity' (Markus and Kitayama 1998). The independent view typically means that the self is conterminous with the body: 'a sense of self with a sharp boundary that stops at one's skin and clearly demarks self from non-self' (Spence 1985). As independent selves, we believe that we are each separate from each other and from the

group. Geertz provides an eloquent, and now classic, description of this way of thinking about the self:

The person is a bounded, unique, more or less integrated motivational and cognitive universe, a dynamic center of awareness, emotion, judgment, and action organized into a distinctive whole and set contrastively both against other such wholes and against a social and natural background. (Geertz 1975)

The cultural model of the person as an independent entity sees the self as a distinct configuration of qualities and characteristics that is integrated into a single, coherent package. 'Others are typically cast as part of the situational context that should not have much influence on person factors' (Markus and Kitayama 1998). People are considered to be egocentric: the focus is upon oneself and on finding out and expressing one's unique attributes. In these cultures, the presumption is that we are knowable through our actions and that our behaviour is largely determined by our unique configuration of internal attributes rather than the exigencies of the external situation. In an extensive series of empirical studies on values across cultures, Schwartz (1992; 1994) has identified higher-order dimensions that summarise the structure of values at the individual level and the cultural level. He surveyed up to forty-one cultural groups in thirty-eight nations. On the basis of his research, we can expect such values as openness to change (self-direction, stimulation and hedonism), self-enhancement (achievement and power), intellectual and affective autonomy, and active mastery of the environment to be important in societies where an individualist, independent conception of the self is dominant. Additional independent values identified by other researchers include freedom of choice, self-determination, personal control, uniqueness, pleasure, competition, fair exchange, individuation, self-fulfilment, assertiveness and privacy. It must be made clear that a self that is independent, autonomous and distinctive is still socially constructed. 'Each distinct, individualized, independent person is collectively constructed through his or her engagement in a cultural world that is organized by and made up of practices and meanings based on the model of the person as independent' (Markus and Kitayama 1998; emphasis added). From a cultural psychological perspective, independent selves are neither socially isolated nor self-contained; their very character is determined by their lifelong participation in society. Even though an individualist culture emphasises being unique and realising one's individual potential, it legitimises only a restricted

range of ways to be a unique and self-actualised person. There is pervasive social pressure to conform to cultural definitions of being a unique (rather than a peculiar) individual. Anglo-American, English, Dutch and other Western and North European cultures exemplify this conception of the independent, separated self.

5.2.4 The interdependent self

The notion of the person as an autonomous entity that can be separated from others and the surrounding social environment is a conception that is ‘a rather peculiar idea within the context of the world’s cultures’ (Geertz 1975). Indeed, people in most cultures around the globe subscribe to the interdependent construal of personhood. As Table 5.1 shows, the interdependent model of the person stresses ‘a relational, interdependent self with fluid boundaries’ (Kagitçibasi 1997). The person is cast as an entity that is embedded in society and culture. The major difference between this and the independent model is the emphasis given to ‘the other’ in people’s self-conceptions. The interdependent self includes relationships with other actors within the boundaries of the self because a person’s relationships to others in specific situations are central to his or her identity. ‘What is a person? Answer: A connected, fluid, flexible, committed being who is bound to others’ (Markus and Kitayama 1998). The focus of individual experience is upon the self in relation to others: it is the other that is fixed as the reference point for defining the self (PriceWilliams 1985: 1007). The interdependent conception of the self is well captured by the traditional African concept of Ubuntu (humanness), which is expressed in the Zulu maxim usually translated as ‘a person is only a person through other people’ (Ramose 1999). Ubuntu is both a world-view and a philosophy of life that expresses mutuality and that shapes human action. It describes personhood as both a state of ‘being-with-others’ and a dynamic process of reaching one’s full potential as a human being through one’s ongoing interaction with others. Viewed through the lens of Ubuntu, a person is not a solitary and self-sufficient entity but is defined in terms of their relationships to others:

Individuals only exist in their relationships with others, and as these relationships change, so do the characters of the individuals ... Ubuntu unites the self and the world in a peculiar web of reciprocal relations in which subject and object become indistinguishable. (Louw 2002)

Interdependent selves are in some sense mere fragments, only becoming fully whole when they fulfill their proper roles within their social groups. People constitute and reveal themselves through social roles and relationships, and, as MacIntyre explains, many cultures, such as the Japanese, have some difficulty in separating a private idea of self from its social aspects:

The individual without and apart from his or her social role is not yet complete, is a set of potentialities waiting to be achieved. (MacIntyre 1990)

The interdependent construction of the self includes aspects of the larger social unit, such as roles and statuses, within the boundaries of the self. This characteristic leads to differences in learning: whereas Anglo-Americans in the USA learn to ‘stand out’, in order to highlight their individuality, people in Japan learn to ‘stand in’, so as to become so identified with the group that they subordinate their individuality (Barnlund 1975). The boundaries of the interdependent self are fluid. (Just as the business firm is a hierarchical order with malleable boundaries, so too is this type of self-system, it seems.) The distinction between fluid and fixed boundaries is highlighted by comparing one of the Japanese concepts of the self (jibun) with that of the West:

The Western concept of ‘self’ refers essentially to the uniqueness of the individual, or the substance of the person, which has maintained its sameness and continuity over time and across situations, although it is recognized as a product of interaction with other humans. Whereas [sic], the Japanese concept of jibun refers to one’s sharing which is something located beyond a boundary of ‘self’ in the Western sense. The amount of one’s sharing varies depending upon dynamics of a situation. Jibun does not have a definite consistent boundary. (Kimura 1973)

5.2.5 Effects of different cultural self-conceptions upon agency beliefs

The concepts of agency, internal LOC and efficacy can have different meanings in different cultures. There is considerable cross-cultural variation in the understanding of these terms.

Effect on conceptions of agency

Personal agency beliefs are a person’s expectations of their capacity to cause events that are desired or intended. These beliefs are a joint function of beliefs about LOC (i.e. action–outcome contingency) and of beliefs about self-efficacy (i.e. personal competence). LOC refers to one’s belief about the degree to which target events are contingent upon human action. Efficacy refers

to one's judgement about the degree to which one can produce the actions on which target events are contingent.

Personal and group agency

More refined distinctions of agency may be required to reflect the diversity of meanings of agency across cultures, especially in group-oriented societies. The first distinction is between the personal and group agency beliefs of the interdependent self. The personal (or role-relevant) agency beliefs of the interdependent self -comprise judgements about his or her causal power to successfully fulfil his or her role in the group (e.g. by way of analogy, to be a good goalie in a soccer team). The personal agency of the interpersonal self is directed towards trying to complete the self through the performance of social roles. 'The collective i.e. interdependent self seeks to gain favorable evaluation from a reference group by fulfilling a particular role and helping to achieve the goals of the group' (Yamaguchi 1994). Interdependent selves regard outward role demands to be the 'really important center of the self' (Smith 1985). MacIntyre explains that in the case of Japan, people differ in the extent to which they succeed in completing themselves through performing their roles:

Table 5.2 Cross-cultural variation in the locus and scope of agency

<i>Feature</i>	<i>Independent conception of self</i>	<i>Interdependent conception of self</i>
<i>1 Agency beliefs</i>		
(a) Personal agency beliefs	One's judgements about one's own causal power to generate target events A combination of <i>personal</i> LOC beliefs (2a) and <i>personal</i> efficacy beliefs (3a)	One's judgements about one's causal power to successfully fulfil one's role in the group A combination of <i>personal</i> LOC beliefs (2a) and <i>personal</i> efficacy beliefs (3a) (as defined in this column)
(b) Group agency beliefs	Not applicable	One's judgements about the causal power of one's in-group to achieve its overall goals A combination of <i>group</i> LOC beliefs (2b) and <i>group</i> efficacy beliefs (3b)
<i>2 LOC beliefs (i.e. contingency expectations)</i>		
(a) Personal LOC beliefs	One's judgements about the extent to which target events are contingent upon certain actions	One's judgements about the extent to which successful fulfilment of one's role within the group (the target event) is contingent upon certain actions, both <i>directly</i> and <i>indirectly</i>
(b) Group LOC beliefs	Not applicable	One's judgments about the degree to which achievement of the group's goals is contingent upon certain collective actions
<i>3 Efficacy beliefs (i.e. competence expectations)</i>		
(a) Personal efficacy beliefs	One's judgements about one's own capacity to produce desired actions	One's judgements about one's own capacity to produce the actions upon which successful fulfilment of one's role within the group is contingent
(b) Group efficacy beliefs	Not applicable	One's judgments about the capacity of one's in-group to produce the collective actions upon which achievement of the in-group's goals is contingent

Primary and secondary agency

There are also other distinctions between types of agency that are important from a cross-cultural perspective. Rothbaum et al. (1982) supply a detailed two-process model which distinguishes between two aspects of agency. According to their model, a sense of agency can entail either (i)

a capacity to change the environment (outside events, other people, circumstances) so as to make it conform to one's goals and wishes, or (ii) a capacity to change the self so as to bring about a better fit between self and the environment. The former notion refers to primary agency; the latter, to secondary agency. The close connection between an independent conception of the self and primary agency is identified by Markus and Kitayama:

The sense of individuality that accompanies this independent construal of the self includes a sense of oneself as an agent, as a producer of one's actions. One is conscious of being in control over the surrounding situation, and of the need to express one's own thoughts, feelings, and actions to others. ... Such acts of standing out are often intrinsically rewarding. ... Furthermore, the acts of standing out, themselves, form an important basis of self-esteem. (Markus and Kitayama 1991)

Similarly, Markus and Kitayama posit a close relationship between the interdependent self and secondary agency:

An interdependent view of the self does not result in a merging of self and other, nor does it imply that one must always be in the company of others to function effectively, or that people do not have a sense of themselves as agents who are the origins of their own actions. On the contrary, it takes a high degree of self-control and agency to effectively adjust oneself to various interpersonal contingencies. Agentic exercise of control, however, is directed primarily to the inside and to those inner attributes, such as desires, personal goals, and private emotions, that can disturb the harmonious equilibrium of interpersonal transaction.

Effects on LOC beliefs

Just as there is cultural differentiation in how people construe personal agency, so too there is cultural differentiation in meanings of LOC and beliefs about the sources of internal control. An independent conception of self -underlies the characterisation of LOC in most psychological research (Furby 1979; Stam 1987). This individualistic bias is significant since LOC might work quite differently in cultures that emphasise the interdependent self.

Personal and group LOC beliefs

In the case of the interdependent self, the nature of LOC beliefs is more complex because a person's perceptions of the relevant in-group clearly matter. As discussed above, the interdependent self is an inseparable part of an intimate in-group. His or her relationships to close in-group members are included in the boundaries of the self. Consequently, a distinguishing feature of interdependent selves is that they each have two sets of LOC beliefs: group-relevant LOC beliefs and personal (or role-relevant) LOC beliefs. A LOC belief is an expectation of the degree of contingency of a class of target events upon a class of actions. In the case of personal LOC beliefs, the relevant target event is meeting the requirements and obligations of one's social role; the relevant class of actions is one's own behaviour. In the case of group LOC beliefs, the relevant target event is achieving the group's objectives; the relevant class of actions is the collective behaviour of the group. Thus, personal LOC beliefs entail judgements about the degree to which successful fulfilment of one's role within the group is contingent upon certain actions, both directly and indirectly. Thus, it would be a mistake to assume that an interdependent self does not have any interest in self-relevant factors (Markus and Kitayama 1991). In contrast, group LOC beliefs entail a person's judgements about the degree to which achievement of the group's overall goals is contingent upon the collective actions of the group as a whole rather than external forces. The soccer analogy referred to earlier can help clarify the distinction between personal and group LOC beliefs of the interdependent self. In the case of one of the team players, let us say the goalie, personal LOC beliefs comprise his or her expectations about the extent to which fending off goals by the attacking team and 'keeping a clean score sheet' (the goalie's social role and target event) depends upon the goalie's own shot-stopping actions (e.g. catching and kicking the ball, doing diving saves) rather than on outfield players' actions or external forces. The goalie's group LOC beliefs comprise his or her expectations about the extent to which the team's scoring goals and winning games (the team's objective and target event) is contingent upon the collective efforts of team-mates (rather than upon external forces, such as luck or biased judgements of a corrupt referee).

Direct and indirect sources of internal LOC

'Internality was equated with a sense of control originating from the self, and externality was equated with a sense of control other than the self' (Chia et al. 1998). In contrast, Chia et al.

argue that for people in group-oriented cultures, such as China, there are sources of internal control that are not limited to the self, narrowly construed. In particular, there are both direct and indirect sources of internal control. The direct source corresponds to that identified by Rotter – namely, the inner self. The indirect source of internal control arises from other members of one's intimate social group whom one sees as extensions of oneself. Thus, people with an interdependent self-conception can still perceive internal LOC through significant others if they believe that target events (such as role fulfilment) are directly contingent on the actions of other close in-group members over whom they themselves exert some influence. As Chia et al. (1998) put it: 'When any extended self in this special relationship group has control, I can feel that I too have control.' In earlier research, this indirect source has been considered a source of external control for people in individualist cultures.

Effects on self-efficacy beliefs

In order to understand the impact of culture (especially alternative self-construals) upon efficacy beliefs, it is useful to distinguish between personal efficacy and group efficacy in much the same way as was done between personal and group LOC beliefs. Perceived personal efficacy refers to one's beliefs about one's own ability to produce the actions upon which success in prospective situations (more specifically, success in fulfilling one's role in the group) is contingent. Group efficacy relates to people's beliefs about their capacity to solve, through collective endeavour, the problems they face as a group as a whole. More specifically, it involves judgements about the group's capacity to produce the particular collective actions upon which achievement of the group's overall goals is contingent. Group efficacy is especially relevant for the interdependent conception of the self with its emphasis upon commitment to a few, small, stable in-groups. Within any group, of course, there can be variability in members' beliefs about the efficacy of their in-group. In particular, people with different statuses or roles within the same group may differ markedly in how they perceive their group's efficacy.¹³ With high interdependence, a person's group efficacy belief is not just the aggregation of that person's perceptions of individual members' capabilities; rather it is the perception of an emergent property of interactive group processes (Bandura 1997). Group efficacy beliefs are likely to depend, among other things, on people's appraisals of the depth, variety and balance of competences in the group.

5.3 Effects of different self-conceptions upon alertness

The distinction between the independent and interdependent construals of the self is important in explaining variations in psychological processes across cultures. This section takes up this theme by investigating the major effects of alternative cultural self-conceptions upon the unit of alertness and other aspects of entrepreneurship. See Table 5.3.

<i>Feature</i>	<i>Independent conception of self (in individualist culture)</i>	<i>Interdependent conception of self (in group- oriented culture)</i>
Primary locus of alertness	Independent, autonomous person	Interdependent members of an in-group
Alertness is most attuned to opportunities that are relevant to ...	direct, personal gain	(i) successful fulfilment of one's social role in the group (i.e. <i>micro-alertness</i>) (ii) collective action by the in-group and successful achievement of the overall goals of the group (i.e. <i>micro-alertness</i>)
Alertness typically manifests itself in ...	individual entrepreneurship	clan, team-based or corporate entrepreneurship that draws upon the pooled talents of interdependent members in the group (e.g. the Chinese family business, Japanese 'quality circles')
Innovation often entails....	<i>generating variety</i> through new combinations of resources (Tiessen 1997)	<i>leveraging resources</i> internally or building close external relations with other firms (thereby pursuing opportunities without regard to the resources already controlled) (Tiessen 1997)
	taking discrete steps that involve independent action	taking connected steps that involve groups and businesses working together
	violating established practices without consensual decision-making	'consensual rule-breaking' (McGrath <i>et al.</i> 1992b; Shane 1994)
	a partitioned sequence of activities	a non-linear, parallel process
	compartmentalised organisation of functions (e.g. shop-floor manufacturing staff are not involved in sales and marketing)	highly integrated organisation (e.g. interdivisional transfers of researchers and engineers) (Harper 1994a)

<i>Feature</i>	<i>Independent conception of self (in individualist culture)</i>	<i>Interdependent conception of self (in group- oriented culture)</i>
Innovation often entails....	'renegade' championing strategies and corporate venturing approaches that free innovation efforts and venturing groups in a firm from the formal corporate structure, organisational norms and rules (Shane and Venkataraman 1996)	firm-wide corporate venturing strategies that are linked to the company's collective goals and norms and that rely upon cross-functional support (Shane <i>et al.</i> 1994; 1995)
Scope for entrepreneurship	Opportunities rarely limited by people's expectations of the boundaries of their society (in the absence of government intervention)	Opportunities possibly limited by partitioning of the social structure and by norms about trading with strangers (at least in some group-oriented cultures that are vertical and 'tight' in their social organisation) (Greif 1994)
Prior localised knowledge of entrepreneur includes ...	richly elaborated knowledge of self and of the abstract and generic attributes of other (classes of) autonomous market participants deep knowledge of objective conditions required to meet the self's needs and desires	richly elaborated knowledge of relationships with other in-group members, position of in-group relative to out-groups, requirements of specific social contexts, and concrete and contextually embedded attributes and roles of other market participants deep knowledge of perspectives, expectations, goals and desires of significant others in the in-group that impinge upon successful fulfilment of one's role
Situational influences on people's alertness	Most alert when working independently on tasks that can be solved by one person (i.e. 'disjunctive' tasks) Most alert when they have individual goals, individual responsibility and individual-based rewards (because then their sense of agency is strongest) Alertness does not depend significantly upon the cultural similarity of the	Most alert when working in their in-group on tasks that require a team effort (i.e. 'conjunctive' tasks) Most alert when they have group-focused goals, shared responsibility and group-based rewards (Earley and Gibson 1998) Alertness is dampened when working in a group of strangers and in culturally heterogeneous teams (Folger 1992)

<i>Feature</i>	<i>Independent conception of self (in individualist culture)</i>	<i>Interdependent conception of self (in group-oriented culture)</i>
Situational influences on people's alertness	<p>Social pressure to develop one's uniqueness and potential (according to cultural definitions of being a unique, self-actualised person) encourages creativity and innovation but channels them <i>within</i> socially accepted bounds</p> <p>Alertness is more generalised and diversified but less attuned to any one particular social situation (partly because individuals belong to many non-intimate groups, they frequently shift from one group to another and their prior knowledge is more generalised)</p>	<p>In the case of those group-oriented cultures that are 'tight' in their social organisation, the need to consider the reactions of in-group members in every situation may inhibit entrepreneurial initiative, creativity and innovation (Liu 1986)</p> <p>Alertness is more finely attuned to specific social situations (because people belong to fewer and more stable groups, their social interactions are less diverse and their prior knowledge is much more contextual)</p>
Information structures relevant to entrepreneur(s)	<p>Low investment in the sharing and coordination of information</p> <p>Less intimate communication between entrepreneurs and other actors</p> <p>Frequent opportunistic withholding of information</p>	<p>High investment in the sharing and coordination of information</p> <p>High level of in-group communication and extensive informal, low-cost transmission of latest available commercial information ('thick information exchange') (Gudykunst <i>et al.</i> 1987; 1992)</p> <p>Much less frequent opportunistic withholding of information vis-à-vis other in-group members (Aoki 1986)</p>
Conflict resolution and alertness	<p>More alert to opportunities to litigate via the courts to obtain or secure a competitive advantage at the expense of rivals</p> <p>More alert to new 'commitment technologies' and contractual innovations that reduce principal-agent problems</p>	<p>More alert to opportunities for non-legal conflict resolution and for middle-ground solutions to opposed opinions when dealing with in-group members (Leung 1997)</p> <p>More alert to the changing requirements of informal institutions that build trust and that reduce the payoff to socially uncooperative strategies (Fukuyama 1995)</p>
Entrepreneurial decision-making	<p>Individual based</p> <p>Potentially rapid decision-making – especially for short-lived arbitrage opportunities</p>	<p>Generally team based, more participatory and consensual</p> <p>Relatively slow decision-making</p>

<i>Feature</i>	<i>Independent conception of self (in individualist culture)</i>	<i>Interdependent conception of self (in group-oriented culture)</i>
Entrepreneurial contracting and its enforcement	Explicit and/or shorter-term contracts	Implicit, ongoing, highly personal, relationships supported by extensive networks
	Entrepreneurs readily enter into contracts with people from different groups and cultural backgrounds	Entrepreneurs prefer to interact with members from their specific ethnic, religious or familial group and they may forgo contracting with particular out-groups even when they perceive profitable opportunities (ignoring agency costs) (Greif 1994)
	High functional division of labour between individuals (in the sense of 'who is to do what') but less structural differentiation among individuals (in the sense of 'who is in charge') (Kashima and Callan 1994)	Lower functional division of labour between individuals but greater structural differentiation among individuals
	Employees are more likely to pursue personal or localised interests within their specific functional unit (thereby increasing contractual problems for the entrepreneur)	Employees more likely to apply skills and knowledge in the overall interests of the firm
	Hierarchical and vertical control in firms	Horizontal communication and coordination among production units
	Higher degree of formal vertical integration of production	Extensive networks of long-term subcontractual relationships (e.g. Japanese <i>keiretsu</i>) (Aoki 1990)
	Contract enforcement is achieved mainly through self-enforcing bilateral agreements, formal control mechanisms and specialised third-party organisations, such as the court system	Contract enforcement is achieved through informal economic and social mechanisms, such as social intimacy, close personal relationships and customs

In contrast to the independent self, for instance, an interdependent self potentially exhibits two types of alertness: micro-alertness and macro-alertness. Micro-alertness is defined as one's propensity to notice opportunities, events and conditions that are specifically relevant to the successful fulfilment of one's role in the group (and that relate to the commitments and obligations that the role confers). Macro-alertness, on the other hand, is defined as one's propensity to notice opportunities, events and conditions relevant to the achievement of the overall goals of the group as a whole, including the propensity to discover profitable opportunities for collective action by the group. It should be noted that micro- and macro-

alertness are two aspects of the alertness of an interdependent self. Macro-alertness is not the alertness of a group. Given the centrality of roles as a constituent of the interdependent self, micro-alertness entails being alert to changes in the perspectives, expectations and goals of significant others in the group that have an impact on the effective operation of one's role. Alertness to these changes helps one adapt oneself to others' needs and demands and to create and maintain a connection to them. Micro-alertness is directed to the immediate requirements of each specific situation and to the key people who make up that situation. It manifests itself in finding new ways of becoming part of various interpersonal

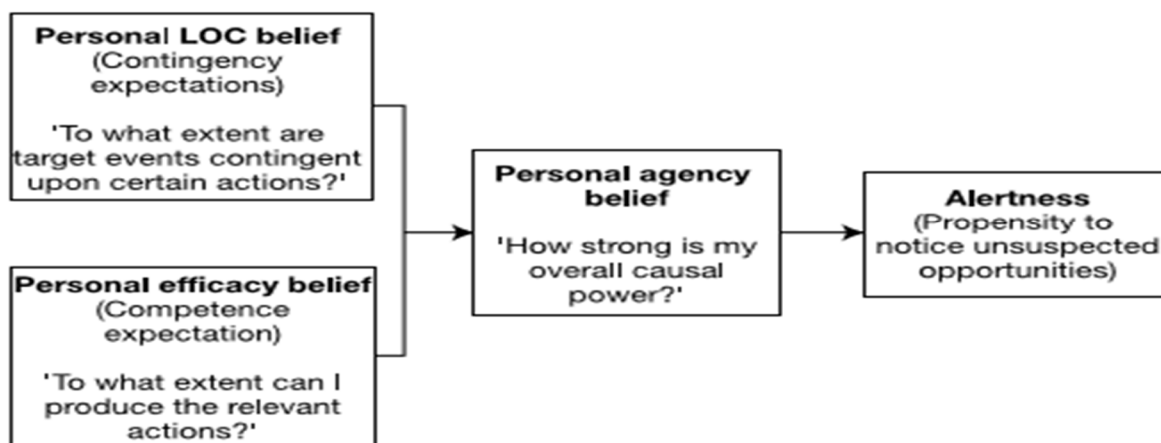


Figure 5.1 Determinants of alertness of an independent self

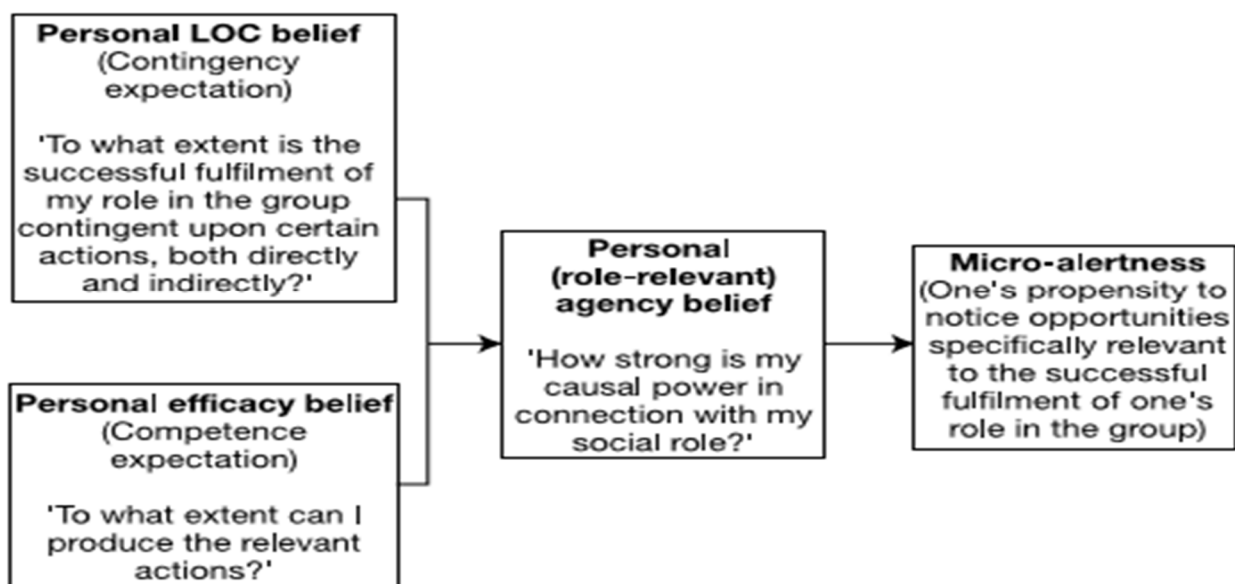


Figure 5.2 Determinants of micro-alertness of an interdependent self

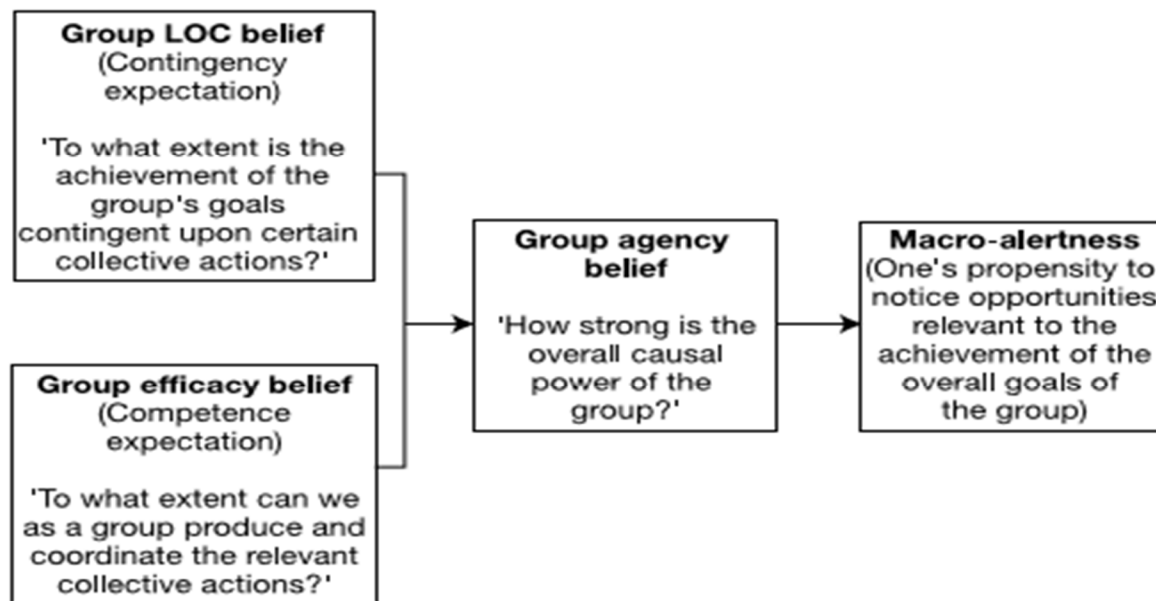


Figure 5.3 Determinants of macro-alertness of an interdependent self

relationships within the group and of enhancing one's goodness of fit with significant others – for instance, by discovering opportunities to create and fulfill obligations and to promote the goals of other in-group members (e.g. one's supervisor or boss). Micro-alertness also entails being vigilant about the process and sequence by which collective decisions will be taken that might have an effect on one's role in the group and one's relationship to others. Macro-alertness relates to noticing opportunities for profitable collective action on the part of the group. It is relevant to the achievement of the goals of the in-group as a whole. It might involve discovering opportunities to compete against rival out-groups. It might involve ideas about new products and new markets that an entrepreneurial team might explore. Macro-alertness might also manifest itself in forming new alliances with other entrepreneurial teams. It includes vigilance towards external signs of danger and potentially threatening events to which the team must adapt. The degree of micro-alertness of an interdependent self is likely to be an increasing function of the strength of his or her personal agency beliefs, which in turn is a function of his or her beliefs of personal internal LOC and personal efficacy. In contrast, macro-alertness depends on the interdependent self's perceptions of the group's agency, which in turn is a function of his or her beliefs of group internal LOC and group efficacy. Micro- and macro-alertness are probably

loosely coupled. For instance, an interdependent self's perception of personal agency (a determinant of micro-alertness) is influenced by his or her perception of group agency (a determinant of macro-alertness). The interdependent self's sense of personal efficacy is after all likely to be influenced by group context and group processes. At least some minimal degree of micro-alertness is necessary (but not sufficient) for non-trivial degrees of macro-alertness: how could one possess a high degree of alertness to relatively distant opportunities for collective action by the group but fail to exhibit one iota of alertness to more proximate opportunities ('right under one's nose', so to speak) that are related to the successful realisation of one's own social role? Thus, some degree of mutual interdependence and positive correlation between these two types of alertness seems plausible.

5.4 Revisiting the cornerstone and convergence hypotheses

In particular, it claims that individualism is neither a necessary nor a sufficient condition for the discovery of profit opportunities. Indeed, the propensity to be alert exists in all individuals and groups of people, whether individualist or group-oriented. Interdependent selves are not necessarily less alert or entrepreneurial than their independent counterparts. Before jumping to the conclusion that a vibrant entrepreneurial economy requires a Western brand of individualist culture, it is recommended that we first take a look at those developing countries in which group-oriented values are prevalent and then see what happens when they adopt political institutions and property laws that can bolster people's perceptions of agency and that can channel their alertness in the economic sphere. Furthermore, this chapter asserts that the cognitive factors that switch on people's alertness are similar across cultures. In particular, people's perceptions of agency – their beliefs in the causal power of the relevant loci of decision-making and alertness – are the main psychological mediators through which culture influences entrepreneurship in all societies. (However, it is acknowledged that the structure and content of agency beliefs do differ between individualist and group-oriented societies. The approach explains how the propensity to be alert works its way through different channels in different cultural contexts.) Although it specifies when certain effects will hold, the cornerstone hypothesis says nothing about how and why culture affects entrepreneurial alertness, the essence of entrepreneurship. It makes no claims about the causal or generative role of cognitive processes (especially agency beliefs) in cultural phenomena. One problem with the cornerstone hypothesis is that it assumes that there is a one-

dimensional, culturally neutral scale for measuring and comparing degrees of entrepreneurship across different cultural groups. However, alertness is a complex perceptual faculty and there is as yet no scale for measuring it that has cross-cultural validity. Opportunities and market events may be perceived differently depending on whether one is looking through individualist or group-oriented lenses (in a manner akin to Ichheiser's 'Kulturbrille' (cultural glasses)). Different units of entrepreneurship (i.e. independent versus interdependent selves) exhibit different types of alertness that lead to differences in the nature of the opportunities that entrepreneurs discover. As explained earlier, interdependent selves have a greater propensity to recognise particular types of entrepreneurial opportunities than do independent selves, and vice versa. Because they are alert to different types of opportunities, it is very difficult to compare the degrees of alertness of independent and interdependent selves in general and absolute terms. For any given opportunity, one type of self may be more or less predisposed to its discovery than is the other. In other words, entrepreneurial alertness is not a contextually independent phenomenon. It is a psychological propensity that is laden with cultural values. Although they are not recognised by the cornerstone hypothesis, situational influences can have a significant effect on how entrepreneurial people are. That is, the alertness of independent and interdependent selves is heightened in different types of situational contexts. For example, the independent self is most alert when working alone on tasks that can be performed by one person (so-called 'disjunctive' tasks) and when operating in organisational contexts that provide individual-based rewards. In contrast, interdependent selves are most alert when working as a team with members of their in-group on tasks that require a team effort (i.e. so-called 'conjunctive tasks') and when they face group-based rewards. An increase in the intensity of out-group competition may also further enhance their alertness. Although there are conceptual and measurement difficulties in comparing people's degrees of alertness across cultures, some tentative claims will be put forward. In particular, in contrast to the cornerstone hypothesis, the approach in this chapter predicts that some group-oriented cultures can generate a high degree of entrepreneurial alertness among their members (at least relative to other group-oriented cultures). In addition, the approach identifies the distinguishing characteristics of those group-oriented cultures in which people are likely to be intensely alert and entrepreneurial. It is argued that the members of group-oriented cultures that are highly entrepreneurial will typically possess a strong sense of personal agency in fulfilling their role within the group as well as a strong belief in their group's

collective agency. They each perceive events that are relevant to both self and group to be contingent on actions, and they perceive both self and group to have the capacity to produce the relevant actions. That is, they typically exhibit a strong sense of contingency (i.e. internal LOC) and competence (i.e. efficacy) at both the personal and group level. They feel able to affect the external conditions that impact upon their roles when necessary (primary agency), and they are confident in their ability to adapt how they perform their social roles when circumstances change (secondary agency). They also consider themselves capable of regulating their inner thoughts when under stressful conditions. They are also confident in their in-group's capacity to coordinate its activities and adapt to new environmental pressures. They consider their group's internal dynamics to be highly functional to the achievement of collective goals. Because the degree of people's alertness is directly related to the perceived strength of their agency, we can expect interdependent selves in such group-oriented cultures to be highly alert to entrepreneurial opportunities that specifically enhance their fulfilment of their role (an expression of microalertness). They are also expected to be alert to rewarding opportunities for collective action by the group (i.e. to exhibit a high degree of macroalertness). Thus, the cornerstone hypothesis is conceptually unsound. The cornerstone hypothesis is a bold proposition that disintegrates upon closer scrutiny. A group-oriented culture that emphasises relatedness between people is not inherently incompatible with robust entrepreneurship. On the contrary, a subset of group-oriented cultures may generate heightened alertness to opportunity on the part of its members, as demonstrated by real-world examples of spectacular entrepreneurial performance in some East Asian nations. The second hypothesis examined in connection with the relationship between culture and entrepreneurship is the convergence hypothesis. This hypothesis predicts that as societies develop, they will all become more alike. In particular, they will come to share individualist cultural values. Like the cornerstone hypothesis, the convergence hypothesis is often expressed at an aggregate level. Group-oriented nations are predicted to become more individualist as they modernise and become more affluent. The cornerstone and convergence hypotheses are right to focus upon the continuum of individualism–collectivism because it is the most significant and coherent dimension of cultural variation in values. However, they fail to emphasise that this dimension is very broad and encompasses many separate elements. Moreover, they fail to focus upon the most fundamental aspect of the individualism–collectivism dimension: cultural self-construals. Culture is a complex symbolic system of shared meanings.

Shared understandings of personhood are artefacts of this cultural system. This chapter argues that culture is a major influence on whether people define themselves as independent entities or as interdependent parts of a larger social whole. Different self-conceptions are a key phenomenon in explaining psychological processes that vary across cultures. The analysis suggests that cultural conceptions of the self are often relatively stable from generation to generation. These self-construals underpin the ingrained identity of a people. Adaptation in cultural conceptions of the self is very slow, especially in relatively homogeneous cultures where a dominant cultural framework is identifiable and tangible. The persistence of group-oriented values and the culture of the relational self in highly developed nations, such as Japan, is a case in point (Iwawaki 1986). Taking a broad historical perspective, MacIntyre observes that:

It is this capacity for adaptive change which suggests that even those radical transformations which Japan has undergone between the sixteenth century and the present are compatible with a certain constancy in the understanding of the self. ... If this is so, then, in certain important respects, convergence, increasing resemblance between Japanese and Americans, is unlikely to occur. (MacIntyre: 1990: 496; emphasis added)

There is no compelling evidence that collectivist cultures that have prospered economically are becoming overwhelmingly individualist in many different behavioural and cognitive domains (see the various studies in Kim et al. 1994a). The conception of the interdependent self is not giving way to that of the independent self. Kagitçibasi suggests that psychological aspects of group-oriented cultures, such as close-knit human bonds, may be expected to endure if they do not conflict with the demands of urban life in modern economies and other social structural changes:

For example, belonging to more than one homogeneous group may be necessitated by urban living and working conditions. However, how one relates to other in-group members and how closely one is interconnected with them may remain the same. Thus, for example, work organizations are prevalent in all urban contexts in the world, but whereas such organizations are typically 'secondary' groups in Western societies, they assume 'primary' group qualities in Japan. (Kagitçibasi 1994: 61; emphasis added)

Furthermore, she suggests that some aspects of individualism in the West are on the wane as people seek out more human relatedness in postindustrial societies. In contrast to the convergence hypothesis and its rigid demarcation between individualist and group-oriented cultures, there is some evidence that individualist and group-oriented cultural elements may coexist in the process of economic and social development. For example, it is incorrect to portray Chinese culture globally as collectivist because it affirms both group-oriented values (e.g. a cooperative orientation) and some individualist values (e.g. self-reliance, individual responsibility) (Ho and Chiu 1994). Mishra (1994) also found a coexistence of individualist and group-oriented values among fathers and sons in eastern Uttar Pradesh in India (see too Sinha and Tripathi 1994). Indeed, Kagitçibasi (1990; 1996) has proposed a coexistence model of selfhood that combines independent and interdependent elements. She claims that intensification of urbanisation in group-oriented cultures weakens material intergenerational interdependencies in the family but does not diminish emotional interdependencies. Because strong emotional interdependencies persist, she argues, an interdependent conception of the self is still the net outcome (i.e. the predominant notion of personhood). Individualism and collectivism should not be characterised as opposing configurations of cultural values as is implied by the cornerstone and convergence hypotheses. They are not opposite ends of a single continuum (Ho and Chiu 1994). We must avoid the trap of 'misplaced polarities' (Gusfield 1967). Independent and interdependent selves are not complete antitheses of one another. An interdependent conception of the self does not imply a total melding of inner self and other. It does not imply that the interdependent self is only ever entrepreneurial when performing team-based tasks. Nor does it imply a fatalistic view that people are always pawns of external forces. Indeed, interdependent selves can see themselves as causally efficacious agents who are the catalysts of events in their lives.

Consequently, interdependent selves do not rely solely upon groupreferential data and group-based expectations when planning and acting in the world. As we have seen, they also use self-referential data to form self-referential judgements of their own personal efficacy, personal LOC and personal agency in connection with their social roles. Thus, self-referenced data perform a similar role for both independent and interdependent selves in the formation of their personal agency beliefs. In addition, as mentioned above, the alertness of interdependent selves has self-referential aspects as well as group-referential aspects. Thus, in contrast to the convergence

hypothesis, significant cultural variety can be expected to persist even among post-industrial capitalist societies as they continue to develop. It is most unlikely that all market-based economies will converge on a unified cultural pattern of individualist values. 'Diversified capitalism' with multiple adaptive peaks is more likely than 'single-peaked capitalism' (cf. Freeman 2000).

Chapter Six - The market-process approach to public policy

The theory of entrepreneurial discovery has implications which go beyond the simple satisfaction of scientific curiosity. The explanation which it provides drastically alters the way in which significant features of the market economy and of contemporary economic reality are understood or appreciated. The differences in understanding should, in turn, entail important modifications ... in the formulation of practical economic policies to permit the economy to reap its greatest potential in efficiency and in prosperity. (Kirzner 1997b)

6.1 Policy goals and assumptions

The general policy approach constitutes what will be referred to as the ‘market-process’ policy programme (MPP). The specification of the MPP arises out of a desire to provide in a succinct and systematic way the key implications of ‘Austrian’ market-process theory for public policy. (For the purposes of this chapter, the term ‘Austrian’ is read to mean the broad subjectivist and market-process school of economic thought.) After defining a public policy programme in more detail, the chapter outlines the specific hard-core assumptions and rules of the MPP. It then examines the relationship of the applied policy analysis of the MPP to the school of theoretical Austrian economics. The next step distinguishes the MPP from two other public policy frameworks based on the ‘market-failure’ paradigm and the ‘perfect-markets’ approach, respectively. It should be noted that this chapter does not aim to come up with detailed and specific policy recommendations for encouraging entrepreneurship. The objective is to provide insights and to suggest guidelines and directions for further policy analysis. For any particular real-world policy problem, the policy recommended will depend upon the specific empirical characteristics of that situation and some assessment of the expected range of possible effects of alternative policies. Detailed policy recommendations are not possible without information about the particular situation. However, we can begin to use the principles described in this chapter to provide examples of concrete policy options. Indeed, Table 7.2 and the surrounding discussion offer selected ‘stylised’ policy prescriptions based on the entrepreneurial-discovery perspective to provide a flavour of the sort of policy recommendations that an Austrian market-process scholar might make in order to encourage entrepreneurship and enhance economic coordination. It also compares these prescriptions with those derived from competing policy approaches.

6.1.1 On the relevance of Austrian market-process theory for public policy

The Austrian theory of entrepreneurial discovery can assist policy decision-makers in solving practical and important policy problems. ‘The strength of the Austrian school can best be gleaned in the application of its theoretical principles to understand real world problems’ (Boettke 1995b). This raises the question: for which sets of policy problems is Austrian market-process theory likely to have a comparative advantage relative to other approaches? Austrian economics can contribute greatly to enhancing our understanding of the big picture – to explaining how markets and entire economic systems operate within different institutional contexts (Yeager 1997a). It has a comparative advantage in examining fundamental questions concerning the evolution and design of institutional frameworks and their implications for the coordination of economic activities and decisions. Its focus is the constitutional and basic institutional structure of society. To use Vanberg’s distinction (2001), the market-process approach favours general regulatory rules that frame market processes rather than specific regulatory commands that intervene in market processes. Its emphasis is on how, if at all, the functioning of markets might be improved indirectly by modifying the super-structural rules of the game of the market economy rather than upon how desired economic outcomes might be brought about directly by altering particular actions by market participants (e.g. price, quality and quantity decisions). Similarly, in terms of Williamson’s taxonomy of four levels of social analysis, Austrian economics has significant value for the second level of analysis, whose aim is to ‘get the formal rules of the game right’:

The second level is referred to as the institutional environment. The structures observed here are partly the product of evolutionary processes, but design opportunities are also posed. ... Constrained by the shadow of the past, the design instruments at Level 2 include the executive, legislative, judicial, and bureaucratic functions of government as well as the distribution of powers across different levels of government (federalism). The definition and enforcement of property rights and of contract laws are important features. (Williamson 2000)

In dealing with the institutional environment, Austrian economics addresses the big policy problems. And given that these problems are most prevalent in societies undergoing significant economic change, the theory of entrepreneurial discovery is especially applicable to examining policy issues related to the transition from a socialist economy (such as East European

economies) and those economies facing or going through a process of liberalisation (e.g. the UK in the 1980s, New Zealand in the 1980s and early 1990s). Austrian economics can provide a richer and more sophisticated story of processes of economic adjustment (including economic growth and development) than mainstream economics. The Austrian theory of entrepreneurial discovery makes policy decision-makers recognise their inability specifically to predict and effectively to control people's reactions to intervention in the market:

To act on the belief that we possess the knowledge and the power which enable us to shape the processes of society entirely to our liking, knowledge which in fact we do not possess, is likely to make us do much harm. ... If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible. He will therefore have to use what knowledge he can achieve, not to shape the results as the craftsman shapes his handiwork, but rather to cultivate a growth by providing the appropriate environment, in the manner in which the gardener does this for his plants. (Hayek 1978: 34)

Although it does not reject possible piecemeal reforms, Austrian economics does serve as an analytical check on the hubris of holistic social engineers. It explains how important institutions, such as money, the common law, and even markets themselves, can evolve spontaneously without deliberate planning or design. It reminds us that undesirable conditions and genuine inefficiencies that might emerge in unregulated markets might well be corrected spontaneously by the future course of market processes without the need for deliberate government intervention. The Austrian approach prescribes more than a modicum of modesty in attempts to reconstruct and replace these spontaneous institutions on the basis of definite blueprints. It 'counsels a certain humility against temptations to overthrow spontaneously evolved institutions and practices merely because their rationales have not been fully understood and articulated' (Yeager 1997a).

Clearly, it is not possible to have coherent policy without objectives. The selection of ends depends on value judgements and is beyond the scope of economic analysis (though economic analysis can clarify the implications of the different ends we may select (Robbins 1932)). Hence, the choice of policy goals depends on policy decision-makers' own value judgements or their

estimates of the value scales of those people they seek to serve. The choice of means (policies) to achieve given ends, however, can be value neutral. In this case, policy analysis does not reflect personal valuations but rather the analyst's conjectures about the degree of success with which particular policies achieve particular purposes – namely, the purposes of those people who are wanting or proposing the particular policies. Economic analysis can help policy-makers decide on the means to be applied for the attainment of the ends they have chosen: 'science never tells a man how he should act; it merely shows how a man must act if he wants to attain definite ends' (Mises 1966). The policy goal has been described loosely so far as enhancing entrepreneurship and market processes. This is not entirely straightforward, however. A policy making use of the spontaneously ordering forces ... must aim at increasing, for any person picked out at random, the prospects that the overall effect of all changes required by that order will be to increase his chances of attaining his ends. (Hayek 1976)

A final comment on policy goals is that the discussion in this chapter is concerned largely with increasing entrepreneurship in isolation of other objectives. The objective of enhancing successful entrepreneurial alertness (and of increasing economic coordination) is taken as given. This chapter does not investigate the advantages and disadvantages of this goal but it does assume implicitly (i.e. invoke the value judgement) that increasing the degree of entrepreneurship and social coordination is worthwhile. That is, a greater degree of coordinatedness in economic activity is assumed to be good (as asserted by some independently established moral philosophy). 'When we identify coordination as being the criterion for economic "goodness", we are asserting that, from the perspective of those whom economists aspire to serve, the function of an economic system is to coordinate the activities of its participants' (Kirzner 2000: 137). The relationship between increasing the level of entrepreneurship in a society and other objectives of public policy is a high priority for future research since economic well-being is only one component of human welfare.

6.1.2 Treating political institutions as given

The approach treats existing political institutions as exogenous. That is, it assumes that the rules of the game of politics ('the political constitution') are given. In particular, it assumes a democratically structured constitutional state, organised on either unitary or federal lines. However, this does not mean that the policy analysis developed in accordance with the MPP is

solely at the sub-constitutional level. Indeed, it can be conducted at both the constitutional and sub-constitutional levels. To the extent that policy analysis involves comparing the properties of the spontaneous market order with those of alternative arrangements (e.g. deliberate organisation, central planning), policy analysis is being conducted at the constitutional level. ‘Opting for the market system is a matter of constitutional choice’ (Vanberg 2001; original emphasis), however implicit that choice might be. Thus, examining the different patterns of entrepreneurial actions and discovery processes that emerge under different kinds of rules of the game (i.e. alternative ‘economic constitutions’) is a constitutional issue. To the extent that policy analysis developed in line with the MPP examines the effects of policy options on competitive market processes within a particular framework of property rights and other constitutionally determined rules, analysis is being conducted at the sub-constitutional level. Although political institutions evolve through internal forces, there is as yet no well-developed Austrian theory of political economy which provides a full account of these endogenous changes or which explains human action in the political sphere. Indeed, Littlechild (1986) has commented that the lack of progress in investigating regulatory discovery and adjustment processes in a political context limits the usefulness and applicability of Austrian insights into current policy problems.³ Accordingly, the MPP does not focus on the political processes by which public policies emerge or the procedures that allow people in the polity to engage in organised collective action. It does not examine decision-makers in political markets or the results of political entrepreneurship. It studies coordination in economic markets but not in political markets, and there are important differences in these two types of process.

The political process, just like the market process, should not be expected to generate optimal allocations. Both are imperfect. Unlike the market process, however, democratic politics does not engender the incentives and information for its own error detection and correction. (Boettke 1995a)

6.2 The MPP

As the name implies, a public policy programme (or, simply, ‘policy programme’) is a set of ideas and rules that policy advisers and decisionmakers can use for thinking about, and for developing, public policy. It is a prospectus for developing a general public policy framework. The notion of a public policy programme must not be confused with concrete policy initiatives

that are often referred to as government programmes (e.g. housing and urban development programmes). As used here, the term ‘policy programme’ is a conceptual apparatus for policy analysis and development. The idea of a policy programme adapts the concept of a scientific research programme which was developed by Lakatos (1970; 1978) in the philosophy of science. Broadly speaking, a scientific research programme is a distinctive framework of scientific enquiry that contains a descriptive and a normative hard core. The descriptive hard core comprises propositions about the nature of the world, which are treated as irrefutable by scientists working within the programme. The normative hard core includes a positive heuristic which is a set of methodological decision rules for solving problems and a set of instructions for developing the research programme. A research programme is also shielded by a protective belt of auxiliary hypotheses and propositions that are subject to scientific testing and experimentation. Similarly, a policy programme is a conceptual framework characterised by two essential components: a set of descriptive hard-core propositions upon which policy analysis is based and a set of rules or heuristics for doing policy analysis (the normative hard core). A policy programme represents a particular perspective on the world. It makes explicit the foundations of our thinking, including the economic foundations of our policy analysis. The hard core and heuristics determine the nature of policy analysis that an adviser gives. The growth of our knowledge requires a set of conventions, which imposes a structure for enquiry (Popper 1959; 1963). Accordingly, a policy programme constitutes a coordinative framework for policy analysis and development. It assists learning by organising the policy-maker’s problem solving and decisions. It coordinates the policy analyst’s choice and interpretation of policy problems, and it guides the analyst’s selection and application of economic theories and models to the solution of those problems. A policy programme performs a useful heuristic role in guiding the policy decision-maker’s search for information and explanations. The policy programme provides general instructions on how institutions and policies should be developed in order to meet policy-makers’ objectives. It guides them in adapting to changes in the environment, and it gives directions on how to respond to feedback about the apparent success or failure of policy. It should be noted that it is not so much the effect of one particular hard-core proposition or rule taken in isolation that is important in developing policy analysis but rather the effect of the policy programme as a whole. Having a hard core is useful because it means that policy analysts do not have to keep returning to square one each time they encounter difficulties or empirical

anomalies. This is particularly important when policy advisers have to provide analysis at short notice and under stressful conditions of great urgency. In practice, much policy analysis rests on the ability to apply rapidly a tentatively accepted framework to policy problems in order to develop policy recipes for the attainment of prescribed goals. Thus, the hard core and heuristics economise on the bounded rationality of policy decisionmakers. In a complex and uncertain world, such rules are an economical way of filtering and analysing information. Specifying the policy programme underlying our policy analysis also helps us build the foundations for fresh strategic thinking.

6.2.1 The hard core of the MPP

The MPP is organised around several key groupings of hard-core propositions that applied Austrian economists and policy analysts believe firmly and decide not to question for now. The hard core includes central assumptions and hypotheses about the nature of the policy environment and the basic tenets of Austrian policy analysis.

H1 Spontaneous ordering processes

There is a tendency in markets towards coordination of individual economic activities.

To assert that there is such a tendency is to make no claim about the frequency with which [actual] coordination comes about. ... The presumption that action is coordinating does not have direct empirical applicability. Nevertheless, it can still be a useful tool in identifying important features of actual markets. (Rizzo 1982: 59)

In other words, there is a tendency for the whole of the economic order based on private property and voluntary exchange to run itself. It is not in the power of policy-makers (or of anyone else for that matter) to acquire the full knowledge that would enable them deliberately to control or replicate this social order.

H2 Dynamic competition

The competitive market is a dynamic process of entrepreneurial discovery rather than a state of equilibrium in which there is no need and no opportunity to compete. The competitive market process tends to discover what goods and services consumers want, how much they are willing to

pay and how goods and services can be produced at lower cost. Changes over time in prices, production, the range of products, plans, knowledge and expectations are more important than prices and output at any point in time. There exist entrepreneurs who adjust prices and modify other elements of the marketing mix (quantities, qualities and product characteristics). Competitive entrepreneurial-discovery processes are the engine of economic development. In other words, economic development is the overall, unintended result of a myriad of individual profit-motivated discoveries of previously overlooked opportunities for trading and innovation.

H3 Market dominance and profit

Neither the number of firms operating in a market nor the magnitude of profits seized is, in itself, a cause for concern. Market dominance may result when there are wide differences in industry participants' alertness to profitable opportunities. Profit arises from successful entrepreneurial activity. It is the reward for discovering and correcting errors in other people's buying and selling decisions. It is not the result of monopoly power. Monopoly rents tend to be transient in the context of competitive market processes, and they are likely to develop and persist in the context of arrangements that inhibit such processes.

H4 Structural uncertainty

Policy decision-makers and economic agents act in an open-ended world of structural uncertainty, complexity and real time. Their knowledge is highly imperfect, incomplete, fragmented, contextual and often tacit. There is real indeterminism in the world of public policy and economic affairs. As a result, policies often have unintended and undesirable consequences. 'Even moderate amounts of intervention produce results that are unsatisfactory from the point of view of the benevolent interventionist' (Rizzo 1992a: 251). Through the operation of an entire complex system, the effects of policy decisions may be very different from, and even opposite to, intentions. 'The competitive-entrepreneurial process, being a process of discovery of the as yet unknown, can hardly be predicted in any but the broadest terms' (Kirzner 1985: 145). Thus, economists cannot provide reliable numerical forecasts of particular events but they can strive to supply qualitative predictions and explanations of the possible effects of alternative policy proposals.

H5 Superior plan-coordinating properties of markets

Government is presumed to be more prone to failure than the market since the incentives to correct errors in public policy are weaker than those to correct poor decisions in the market, and the information requirements for central planning (vis-à-vis decentralised decision making in markets) are logically and practically impossible to fulfill. ‘The profit and loss system has greater coordinating properties than any other feasible system of allocating resources’ (Rizzo 1992a). In general, alleged cases of ‘market failure’ tend not to result from inherent deficiencies of the market as a type of economic organisation but from shortcomings in the framework of laws and institutions within which the market operates (see Kirzner 2000).

H6 The spontaneous origin of money, and monetary disequilibria

Money is the spontaneous outgrowth of market activity rather than the product of state action or a social contract (Menger 1892; 1994). Money is not merely one good among many (e.g. the numeraire in a general equilibrium system), but a good whose (near) perfect liquidity gives it an influence over economic activity qualitatively different from any other good. It is the medium through which almost all exchanges take place. (Horwitz 2000)

The emergence of money makes possible a complex division of labour, and it enables entrepreneurs to make profit and loss calculations. Excess demands or supplies of money affect all markets and weaken the capacity of markets to perform their coordinative function. The way that money supply increases enter the market affects how and when particular banks, customers and sectors receive additions to their money balances. It thereby affects the pattern of market exchanges and distorts the array of relative prices and the intertemporal structure of capital. In a fully market-driven monetary regime or ‘free banking’ system, the quantity of money would be an unintended result of a market-discovery process involving individual customers and private profit-seeking banks that produce competing brands of currency (redeemable in some base money) (Selgin and White 1994).

H7 Extra-market institutional framework

The market process relies upon the presence of extra-market (including governmental) institutions that support processes of discovery, production and exchange, such as the emergence

of private property rights, arbitration in disputes about the interpretation of such rights and freedom and enforceability of private contract (Kirzner 2000: 77–87). These extra-market institutions include widely shared ethical principles that require us to respect the truth and other people's property. The best way to improve the performance of markets is to improve the framework of rules and institutions that underpin them rather than to try to reconfigure final market outcomes. An institutional framework that maximises individual economic freedom (consistent with equal freedom for all) is most conducive to entrepreneurship and economic development.

H8 Methodological individualism and subjectivism

Economic phenomena arise from the actions or inactions of individuals. Individuals engage in purposeful behaviour: they try to reach ends and goals they have chosen; and they act in order to remove or alleviate some uneasiness or dissatisfaction with the state of their affairs (Mises 1966). Only individual economic agents have aims, beliefs and preferences, and only individuals can make decisions. Individuals inevitably differ in their purposes, judgements, preferences, knowledge, perceptions, expectations and degree of alertness. Different people know different things about resource availabilities, technology and consumers' wants. Consequently, knowledge is localised and dispersed.

H9 Subjective costs and benefits

The costs and benefits that determine choice are unique to the economic actor and are inherently subjective. The true character of the cost of adopting a course of action is that it reflects the chooser's own evaluation of the utility of the best alternative opportunity that must be forgone as a result of choosing (Buchanan 1973; Rizzo 1994). It follows that 'social cost' and 'net social benefit' (e.g. from a change in government policy) cannot be objectively measured. Ultimately, public policy must depend on the value judgements of the policymakers or of their own estimates of the value scales of those they wish to serve.

H10 Non-neutrality of government intervention

No government intervention (in the sense of a specific act aimed at a particular result) is ever neutral (Rothbard 1981). All regulatory commands, taxes, and activist monetary and fiscal policies have real effects on economic activity.

Though they can be of various levels of complexity, generality and abstraction, the hard-core propositions tend to be high-level postulates and hypotheses upon which policy decision-makers build their analyses, advice and choices. These fundamental presumptions correspond to Schumpeter's (1954) pre-analytic vision and to what Converse (1964) calls 'central ideaelements' in a person's political 'belief system'. They are the propositions from which the policy decision-makers derive all others in elaborating their policy approaches. In a sense, these assumptions determine and entail all the lower-level predictions and prescriptions that policy analysts and advisers make about the world.

They distort the formation of relative prices and hamper processes of entrepreneurial discovery and economic coordination. Developing and implementing supposedly 'efficient' regulatory commands (e.g. externalities taxes) and 'optimal' monetary and fiscal policies entail knowledge problems akin to that of central economic planning. Government interventions in market processes not only change the relative desirability of already perceived alternative courses of action. They also distort or weaken the incentive to discover as yet unnoticed opportunities or courses of action (Kirzner 1985). A policy of limited government intervention into the market process generates unintended consequences that increase the likelihood of further intervention.

H11 Path dependence

History matters and so do the timing and sequencing of changes in institutions and public policies. The process by which institutions and policies develop is significant because it constrains future choices of both economic actors and policy-makers.

Historical events can have an effect in the short run, on how a market or economy evolves, and this short run effect can, in certain circumstances, be maintained, or amplified in such a way that it changes the long run evolution of that market or economy. (Cowan 1995)

Economic processes in real time, such as learning in the market, innovation and economic development, are irreversible and path dependent. These processes always run asymmetrically because they entail novelty.

Though they can be of various levels of complexity, generality and abstraction, the hard-core propositions tend to be high-level postulates and hypotheses upon which policy decision-makers build their analyses, advice and choices. These fundamental presumptions correspond to Schumpeter's (1954) pre-analytic vision and to what Converse (1964) calls 'central ideaelements' in a person's political 'belief system'. They are the propositions from which the policy decision-makers derive all others in elaborating their policy approaches. In a sense, these assumptions determine and entail all the lower-level predictions and prescriptions that policy analysts and advisers make about the world.

6.2.2 The heuristics of the MPP

A policy programme also contains a set of rules or heuristics that we use to guide policy analysis and development. This set of rules is just as 'hard' as the hard core. These rules are the hard core's normative component. They can be stated in both positive terms ('Do x') and negative terms ('Don't do y'). Positively expressed, these rules specify which analytical methods we are to apply to policy problems. They guide how we identify, interpret and deal with possible policy problems and how we develop tentative solutions. Negatively stated, these rules indicate which kinds of policy analysis and methods are to be avoided. They specify what we must not do. In other words, the rules of a policy programme may prescribe or proscribe particular techniques of thinking. The next box specifies the heuristics of the MPP. Many of these sets of rules correspond to a relevant hard-core assumption, so that there is a high degree of complementarity between the various components of the MPP. The pieces of the programme fit together into a coherent pattern. (Note that some categories of heuristics have been combined because of substantial synergies between them, such as exists between rules about dynamic competition and market dominance. Hence, the labelling of these rules does not correspond perfectly with that of the hard-core assumptions.)

R1 Spontaneous ordering processes

- Seek to explain complex social phenomena in terms of spontaneous ordering processes.

- Take account of potential spontaneous ordering processes (especially entrepreneurial-discovery processes), and their strength and speed, in analysing perceived problems with market outcomes and investigate the reaction of spontaneous market forces to government intervention.
- Assess rules of the game and institutional arrangements according to the principles of certainty, generality and equality. Determine the extent to which rules will be stable and predictable, the degree to which they can be applied without arbitrary discretion and the extent to which they apply equally to everybody, including those who govern.
- Examine the pattern of outcomes arising from market processes rather than particular results, and acknowledge that the particular results that emerge from the choices of market participants must remain indeterminate.
- Pay particular attention to the factors that can frustrate the attainment of coordination of economic activities in real-world markets. In particular, identify the effects of legal rules and policies on the scope for voluntary mutually beneficial exchange.
- When economic activities appear disorganized and the policy goal is greater coordination, search for the source of the 'relevant communication breakdown among economic agents' (Rizzo 1982: 64).
- If in given circumstances government intervention is deemed necessary to support the supply of particular collective goods, then do so in a manner that as much as possible avoids impairing the spontaneous forces of markets for other goods and services (Hayek 1979: 46).
- Determine how to conduct fiscal affairs so as to give greatest scope to market forces in the private sector.

R2 Dynamic competition, market dominance and profit

- Treat the market as an open-ended, dynamic competitive process. Do not base policy analysis upon 'single-exit' economic models, that is, closed models that yield a determinate equilibrium.
- In tracing out the direct and indirect effects of public policies, pay particular attention to the impact on entrepreneurship and new market entry. Focus upon the effects on: the incentive for entrepreneurs to discover arbitrage, speculative and innovative opportunities; the incentive for,

and ability of, entrepreneurs to exploit the opportunities that they have discovered; the pattern of entrepreneurial activity; and the degree of people's entrepreneurial alertness, including its psychological determinants. Identify institutional barriers to entrepreneurship, examine the effects of policies on competitive selection pressures, and consider the effects of policies on entrepreneurial choices with respect to inputs, outputs, production, prices, quantities and qualities.

- Identify sources of monopoly power and monopoly rents. Focus on discovering which arrangements or government-imposed barriers may be inhibiting competitive market processes from reducing or eliminating these rents.
- Do not base policy analysis on a priori views about what the market structure or the size distribution of firms should be.
- Recognise that starting up a new firm is neither necessary nor sufficient for an act of entrepreneurship.

R3 Structural uncertainty

- Recognise the severe knowledge problems inherent in centralised decision-making and the bounded rationality of policy-makers (especially government planners) in a complex and uncertain world. Avoid any 'pretence of knowledge'.
- Recognise that, in complex economic structures, policies may have effects that are not only different from, but also the opposite to, those intended. Attempt to identify the range of such possible policy effects.
- Recognise that as policy analysts and decision-makers, we can only learn from our mistakes. Proceed, step by step, carefully comparing the results expected with the results achieved. Always keep on the lookout for the unintended undesirable consequences of any policy initiative (Popper 1961).
- Favour qualitative predictions of likely consequences of policy options rather than spuriously precise numerical forecasts.

- Use econometrics as one tool to explain complex historical phenomena but do not interpret econometrically derived relations as universally applicable, time-invariant relations (Rizzo 1978: 53).

R4 Comparative institutional approach

- Take account of the institutional rules of the game in which economic processes are embedded.
- Seek to improve the functioning of markets indirectly by improving the rules of the game that frame market processes rather than directly by ad hoc interventions in the market order (Vanberg 2001: 40–41).
- Search for the source of alleged ‘market failures’, arising from ‘externalities’, in potential loopholes in the institutional (especially property rights) framework within which markets operate. Do not attribute such undesired market outcomes to the failure of the market to coordinate plans with respect to that framework (Mises 1966: 654–661; Kirzner 2000: 86).
- Recognise that the error-correcting mechanism of regulatory processes is likely to be weaker than that of the market.
- Avoid using the standard of Pareto efficiency because it presumes omniscience on the part of the observing economist (Hayek 1948: 104–105).
- When the policy goal is greater economic coordination, judge the performance of an economy or economic system not only by the efficiency with which it allocates given and known resources at a point in time (taking as given production technologies and consumer tastes) but also, and more importantly, by the speed with which it discovers and responds to new opportunities over time. Evaluate institutional arrangements in terms of their potential to inspire entrepreneurial discovery of genuine error (i.e. previously overlooked opportunities) (Kirzner 1992: 191).

R5 Money and monetary disequilibria

- Treat seriously money and its surrounding institutions by emphasising money’s role as a generally accepted medium of exchange that lacks a price and a unique market of its own (Yeager 1997b: 228).

- Recognise that money plays a crucial role in competitive discovery processes and price formation in real-world markets.
- Recognise that ‘any analysis of excesses or deficiencies in the money supply must involve the institutions that are responsible for supplying money’ (Horwitz 2000: 4).
- Recognise that changes in the nominal supply of money (with money demand unchanged) frustrate the coordination function of markets because they systematically distort the formation of relative prices and entrepreneurial plans and because they have real (i.e. non-neutral) and unsustainable effects on the intertemporal structure of heterogeneous capital.
- Identify the relative-price effects and allocative (or ‘first-round’) distortions of a monetary disturbance (e.g. a money supply increase required to maintain price-level stability in a growing economy) (Garrison 2001: 5).
- Recognise that a recession (following inflationary credit expansion) is the recovery stage of the business cycle, in which entrepreneurial errors and wasteful uses of capital are revealed and corrected (Rothbard 1963: 20–21).

R6 Individualism and subjectivism

- Develop policy analysis in a way that is consistent with the principles of methodological individualism. That is, make the individual decision-maker the unit of analysis in policy analysis. Explain economic phenomena and policy problems in terms of the valuations, perceptions, expectations, choices and behaviour of individual economic agents (e.g. individual consumers, producers, investors, entrepreneurs, etc.). Base policy analysis on economic theories that are consistent with methodological individualism.
- Consider the impacts of public policies on individual decisionmakers’ goals, incentives, degree of entrepreneurial alertness, expectations, knowledge (including knowledge of constraints and opportunities available), learning behaviour, the revision of their plans and the compatibility of their actions with those of other people. Pay particular attention to the expectational element of policy analysis and consider whether the policy or policy change can be credible and effective in light of its effects on people’s expectations and their learning from experience.

- Determine whether individuals will acquire the knowledge necessary to modify their conduct in line with policy-makers' intentions. Identify what type of information people need to make decisions and investigate how they can be expected to acquire that information, once the policy is implemented.
- Determine whether the individuals involved have the incentive to change their behaviour in line with policy-makers' intentions. Investigate whether it will be in the self-interest of individuals to act in the way desired by policy-makers, once the policy is implemented (i.e. determine whether the policy is incentive compatible).

R7 Subjective costs and benefits

- Emphasise the subjectivity of costs and benefits in policy analysis. Recognise that 'cost must be borne exclusively by the person who makes decisions' and that 'cost cannot be measured by someone other than the chooser because there is no way that subjective mental experience can be directly observed' (Buchanan 1973: 15).
- Refuse to recognise 'meaning in statements concerning the "welfare of society" that cannot, in principle, be unambiguously translated into statements concerning the individuals in society (in a manner which does not do violence to their individuality)' (Kirzner 1992: 181).
- Do not accept analyses or statements that depict the 'economic well-being of society as expressible in terms (such as physical output) that are unrelated to the valuations and choices made by individuals' (Kirzner 1992: 181). Do not depend upon aggregate notions of welfare, such as gross domestic product.
- Reject standard neoclassical welfare analysis of public policy and do not rely on social cost-benefit analyses of policies (Cordato 1992).
- Do not attempt to provide a basis for policy decisions by trying to measure the relative utilities or satisfactions of different persons.

R8 Non-neutrality of government intervention

- Identify both the direct effects of the initial government intervention as well as the indirect effects that result from subsequent interventions likely to be required to address negative unintended consequences of the former government action.
- Identify the likely relative-price effects (i.e. the standard or Type-I incentive effects) of a regulatory command or tax and examine how it encourages or discourages decision-makers from selecting particular actions out of a set of already perceived alternative courses of action. The rules of the MPP tend to be general in nature, recommending how to do policy analysis rather than elaborating specific policy prescriptions. They are general rules whose application to any particular policy problem will require detailed empirical information about the specific circumstances of time and place. Of particular interest are the rules that relate to the non-neutrality of government intervention (H10, R8). The heuristics of the MPP direct us to trace out in detail the full spectrum of effects of different types of government intervention (in the sense of specific regulatory commands aimed at particular results). In particular, it directs us to identify and explain the largely unintended consequences of public policies for entrepreneurial discovery and market processes. More than any other policy approach, the MPP quite rightly requires us to evaluate the hidden ‘dynamic effects’ of government intervention, such as the stifling and misdirection of entrepreneurial
- Consider the potentially significant negative effects (i.e. the discovery or Type-II incentive effects) of a regulatory command or tax upon barriers to entrepreneurial entry and the incentive of entrepreneurs to discover as yet unnoticed opportunities or courses of action that might otherwise have been discovered but now will not be.
- Consider how a government intervention enhances the potential of opportunities to be discovered and exploited that would not have existed in the absence of the intervention and that are superfluous to the process of market coordination (another discovery effect of intervention).
- Consider the effects of government intervention on entrepreneurial adjustment in both the original market that was the target of the intervention and adjacent markets.
- Identify the likely consequences of a government intervention for heterogeneous elements of the intertemporal capital structure.

R9 Path dependence

- In explaining economic phenomena and analysing policy issues, consider the genesis of those phenomena and issues. That is, examine the historical process that gives rise to their emergence.
- Emphasise obtaining empirical and historical information about the relevant features of the policy problem.
- Recognise path dependence in the analysis, design and implementation of policies.
- Identify potential bottlenecks arising from particular timing and sequences of policy options.

The rules of the MPP tend to be general in nature, recommending how to do policy analysis rather than elaborating specific policy prescriptions. They are general rules whose application to any particular policy problem will require detailed empirical information about the specific circumstances of time and place. Of particular interest are the rules that relate to the non-neutrality of government intervention (H10, R8). The heuristics of the MPP direct us to trace out in detail the full spectrum of effects of different types of government intervention (in the sense of specific regulatory commands aimed at particular results). In particular, it directs us to identify and explain the largely unintended consequences of public policies for entrepreneurial discovery and market processes. More than any other policy approach, the MPP quite rightly requires us to evaluate the hidden ‘dynamic effects’ of government intervention, such as the stifling and misdirection of entrepreneurial-discovery processes and the distortion of the intertemporal capital structure. Consequently, unlike other policy approaches that ignore the entrepreneurial discovery process, the MPP is less likely to understate the adverse consequences of regulatory interferences in the market and less likely to understate the potential beneficial effects of economic liberalisation. In the case of each government intervention, the MPP requires us to consider various types of unintended consequences for entrepreneurial discovery and economic coordination (Ikeda 1997).

In particular, we are instructed to assess the:

1. Direct effects that result from the initial intervention;
2. Indirect effects that result from subsequent interventions likely to be required to address unintended problems caused by the initial intervention;

3. Internal consequences that affect coordination in the particular market that is the original target of the intervention;
4. External consequences that affect coordination in adjacent markets for complementary and substitute goods and services.

In analysing each of the above effects, we must also examine the standard (or Type-I) incentive effects that change the relative desirability of already perceived alternative courses of action. More importantly, for each of the above, we must also examine and emphasise the discovery (or Type-II incentive) effects that change the propensity to discover as yet unnoticed opportunities or courses of action. The analysis of discovery effects requires us to investigate how an intervention might generate impediments (such as barriers to new market entry) that inhibit entrepreneurial discovery and the exploitation of opportunities within and between markets. It also requires us to examine how government interference in the market might create ‘wholly superfluous’ entrepreneurial opportunities (e.g. tax loopholes) that would not have existed in the absence of the intervention(s). As a general observation, it is worth noting that the MPP rejects ‘singleexit’ methods of policy analysis (Latsis 1972; 1976b). Austrian policy analysts do not see their job as calculating the optimal policy:

In Austrian thinking, the task is not primarily one of computing the optimal solution to a well-defined ‘problem’, but rather one of discovering the ‘problem’ in the first place (and the possibility of making some improvement), then gathering and utilising the necessary information, and finally implementing an improved solution. (Littlechild 1986)

It is for this reason that the MPP tends to emphasise considering spontaneous ordering processes in policy analysis (H1, R1).

Finally, it should be noted that these rules are heuristics, not algorithms that entirely and deterministically direct policy analysts’ choices. They provide plenty of scope for the creativity of policy decision-makers.

6.2.4 The relationship of the MPP to the Austrian school of economics

The MPP deals purely with applied economic and policy analysis, and as such it needs to be distinguished from the school, or more formally, the scientific research programme, of

theoretical Austrian economics. The Austrian scientific research programme has been specified precisely by Rizzo (1982) and Langlois (1982). In contrast, the specification of the MPP is by its very nature less exact. The MPP involves the practical utilisation of the provisionally accepted results and methods of the Austrian scientific research programme. For their purposes, policy-makers take the ‘well-corroborated’⁷ hypotheses and predictions of the Austrian research programme largely as given and adopt these hypotheses as a basis for policy analysis and action. From the point of view of policy decision-makers, the Austrian scientific research programme is relatively autonomous. They treat it as a decomposable system, which is not affected by their experiences of success or failure in public policy. Similarly, theorists in Austrian economics consider that their discipline develops largely independently of the verdict of policy experiments. There is some overlap between the hard cores and heuristics of the MPP and those of the Austrian scientific research programme. For instance, the spontaneous-ordering postulate (H1) is in the hard core of the MPP, and it is also in the hard core of the Austrian economics research programme.⁹ However, they need not coincide entirely. Public policy-makers may consider propositions to be in the hard core of the MPP even though they are only part of the auxiliary protective belt of the Austrian economics research programme. H3 on market dominance and profit, H7 on the extra-market institutional framework and H11 on path dependence may fall into this category. Finally, it must be emphasised that this specification of the MPP is not the only conceivable policy programme derivable from modern Austrian economics. Other variants are clearly possible and the programme can be expected to evolve over time. For instance, a follower of Rothbard’s approach is likely to modify or remove the hard-core proposition H7, which assumes a role for government in setting rules of the game, and develop an anarcho-capitalist variant of the MPP which denies the need for a publicly provided institutional framework. In addition, Austrian economists who place a high value on positive freedom could conceivably develop a policy programme based on Austrian economics that implies a different role for government. Thus, it is conceded that there is more to Austrian economics and policy analysis than market-process theory. A greater emphasis upon other important areas within modern Austrian economics, such as business cycle theory, monetary theory and capital theory, might contribute to other distinctly Austrian policy approaches. However, the Austrian market-process theory is sufficiently central to the revival of interest in Austrian ideas that it warrants individualised attention (Kirzner 1997a).

6.3 Comparison of the MPP with other policy programmes

Just as there are several schools of economics, so too there are potentially several public policy programmes. Indeed, the existence of competing policy programmes is potentially more profitable in terms of increasing our knowledge of market-preserving institutions and public policies than is a situation in which a policy programme has achieved monopoly. This section compares the MPP with two other policy approaches: the ‘market-failure’ policy programme and the ‘perfect-markets’ policy programme. These policy programmes represent three readily identifiable perspectives on policy analysis, which, although interrelated, are distinct enough to warrant comparative analysis. This classification scheme is not idiosyncratic or arbitrary. It is familiar to many economists and policy analysts, and they often see themselves as adopting one or other of these approaches. The taxonomy of policy approaches is more analytical than sociological. It classifies policy programmes by the particular stance they take regarding the workings of the market. It seeks to describe objective interrelations among ideas. Each policy programme provides principles that are sufficiently precise to provide clear guidance on policy.

6.3.1 The perfect-markets policy programme

The first of these programmes, the perfect-markets policy programme, considers that the neoclassical model of perfect competition provides an accurate description of most real-world markets – that is, the conditions of the real world often match the approximations of the model. According to this programme, unregulated markets generate economically efficient outcomes. Consequently, proponents of this programme often claim that there is a very minimal role for government in the economic sphere. Unlike the MPP, which depicts the market as a dynamic process of discovery in disequilibrium, the perfect-markets policy programme relies upon an equilibrium market-clearing perspective, and it often seeks to analyse economic behaviour and policy problems within a general equilibrium setting. It focuses upon states of equilibrium in which there are no profit opportunities. It assumes that all economic agents are consistent and successful optimisers within the limits of their information. They are limited to economising in the allocation of given and known means to achieve a set of given and known ends. Economic decision-makers are seen to be forward looking and to have rational expectations. They do not make systematic errors in evaluating their environment and they typically have true actuarial knowledge of the past, present and future. They do not face structural uncertainty. The focus on

perfect markets sufficiently captures the dominant perspective of the Chicago school that it seems reasonable to regard this policy programme as in some sense the ‘essence’ of the overall Chicago approach. However, the perfect-markets policy programme is also neoclassical in a broader sense to the extent that it adheres to the tenets of maximising behaviour, stable preferences through time and market equilibrium, and to the extent that there are perfect-markets theorists who are neoclassical but not Chicago economists. The perfect-markets approach includes policy analysis derived from Friedman’s ideas on economic methodology and monetarism, Stigler’s theory of search, Becker’s theory of human capital and Lucas’s and Sargent’s elaboration of the new classical macroeconomics. New classical economics is a paradigmatic exemplar of the perfectmarkets programme. Its proponents believe that we can explain short-run macroeconomic fluctuations while maintaining the assumptions of the classical economic model. Indeed, they believe that the Walrasian general equilibrium model is a good approximation of the operation of actual economies. They assume that the economy is efficient, that economic actors are fully rational and process available information efficiently, that they hold rational expectations about the future, that prices are fully flexible and adjust instantaneously to clear all markets even in the short run, and that all resources are fully employed (Hoover 1988). For instance, as a leading new classical explanation of macroeconomic fluctuations, real-business-cycle theory asserts that the labour market and other markets always clear, with wages and prices adjusting swiftly to any exogenous shocks in technologies (see Plosser 1989). Real-business-cycle scholars base their policy recommendations on simple economic models of markets that assume perfect information, rational expectations, perfect competition, zero transaction costs and a complete set of markets. New classical economists typically conclude that systematic monetary and fiscal policy cannot affect real outcomes, so that government policy is ineffective.

6.3.2 The market-failure policy programme

The market-failure (or imperfect-markets) view is much less sanguine about the extent to which the real world corresponds to the assumptions of the model of perfectly competitive general equilibrium. Market-failure proponents believe that, in general, market economies are not (constrained) Pareto efficient. They often see significant discrepancies between the model and what they observe when they study actual markets. In their eyes, these discrepancies can arise

because actual competition in factor and product markets is limited (e.g. small-numbers bargaining problems, monopoly), transaction costs are high, people are unable to appropriate all the benefits of their investment, prices are sticky in the short run, information is imperfect or unevenly dispersed between buyers and sellers, people have short time horizons, markets are incomplete (especially markets which distribute risk), factors of production are immobile or indivisible, or because goods have externalities (spillover effects) associated with them. The approach argues that prices, wages and interest rates will not adjust quickly to market-clearing levels. In its crudest formulation, this programme holds that the existence of 'market failures', where one or more of the assumptions of the perfectly competitive model are violated, implies that there is necessarily some scope for collective or government action of some sort to improve allocative efficiency. Accordingly, central agencies that are not governed by profit and loss criteria can better perform the usual allocative functions of a market in situations where markets fail or are more costly than substitute arrangements (Noll 1977). Government intervention in the market can make everyone better off, and it is often required to stabilise the level of economic activity. More sophisticated proponents in this programme contend that, even if a market failure is identified, problems with government action (i.e. 'bureaucratic failure') mean that government intervention may not improve economic efficiency. However, they would still hold that there are significant market failures that require at least selective intervention by government in the market. The market-failure approach represents the dominant perspective on policy analysis derived from much of mainstream neoclassical economics (excluding Chicago). The approach also reflects the policy perspective of new Keynesians, such as Mankiw, Gordon and Stiglitz, who, although not necessarily regarding themselves as neoclassical economists, adopt neoclassical tools of analysis (such as constrained optimisation and rational expectations equilibrium) but reach Keynesian policy conclusions about the frequent need for government intervention to stabilise the aggregate level of economic activity. 'Although new Keynesianism tends to focus on disequilibrium or non-market-clearing phenomena, analysis is conducted within the standard neoclassical equilibrium framework' (Keenan 1994). The basic argument put forward by an important strand of new Keynesianism (in which Stiglitz is a major figure) is that markets fail to function perfectly because participants typically have imperfect and asymmetric information. Even when prices and wages are flexible, these market failures exacerbate the shocks that an economy experiences, increasing both the magnitude and persistence of their

effects, and can lead to high levels of unemployment and sharp fluctuations in aggregate output (Greenwald and Stiglitz 1993). Consequently, these new Keynesians advocate structural reform of labour and financial markets. Their policy analysis focuses upon the causes and effects of labour- and capital-market failures arising from incomplete contracts, such as imperfect indexing (as occurs, for example, when debt contracts are denominated in nominal terms). Other variants of new Keynesianism emphasise macroeconomic market failures arising from the stickiness of nominal prices for goods (e.g. the menu cost theory), nominal wage rigidity (e.g. long-term contract theories), imperfect competition and game-theoretic coordination failures.

6.3.3 Comparing the hard cores and heuristics of the three policy programmes

One of the most significant distinctions of the MPP approach is that it does not, unlike the other two policy programmes, use the perfect-competition model either as a description of actual markets or as a benchmark for evaluating markets when conducting policy analysis. As the name suggests, this policy perspective focuses upon the processes of market adjustment rather than upon states of market equilibrium. Although it recognises general economic interdependence between different markets (especially factor and product markets), the MPP does not focus upon multi-market equilibria. The market is treated as an open-ended, indeterminate, dynamic competitive process. The MPP is concerned with comparing the outcomes arising from alternative real-world institutional arrangements rather than with comparing the real world with some ideal of perfect competition. More specifically, the MPP can be distinguished from the other policy programmes in terms of its domain of enquiry and methodology. The domain of enquiry refers to the sets of policy problems and issues with which the programme is primarily concerned. To a greater degree than the other policy programmes, the MPP focuses mostly upon problems arising from a breakdown in the coordination of economic plans. Adherents of the market-process approach aim to explain observed market outcomes in terms of spontaneous economic processes and when economic activities appear disordinated (or when market outcomes are considered undesirable in some other respect) they first seek to identify potential impediments to the proper functioning of these spontaneous processes. Correspondingly, the heuristics of the MPP direct the policy analyst to pay particular attention to factors that can frustrate the spontaneous ordering of individual activities in real-world markets.

Table 7.1 Comparison of public policy programmes

	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
<i>Hard-core propositions:</i>			
Spontaneous ordering processes	Yes. Entrepreneurs' pursuit of profits sets in motion a <i>tendency</i> towards coordination of economic activities, though complete coordination may never actually be attained. Market ignorance may prevail for an indefinite period until entrepreneurs discover and correct it	No. Market adjustment is virtually <i>instantaneous</i> , so that markets essentially always clear. Prices fully reflect all available, relevant information at (almost) every instant of time. There are no <i>processes</i> of spontaneous ordering in real time	No. Markets do not solve the coordination problem efficiently. Wages and prices do not adjust rapidly to market-clearing levels. Prices are 'noisy' (they do not aggregate information perfectly). Natural economic forces can magnify economic shocks (Greenwald and Stiglitz 1993)
Dynamic competition	Yes. The competitive market is a dynamic process of entrepreneurial discovery. Entrepreneurs set and adjust prices, choose quantities and qualities and introduce new products, all under conditions of competitive rivalry	No. In general, an economy is (approximately) in long-run competitive equilibrium, with all profit opportunities captured and no further adjustments necessary. Most market participants are price-takers (Reder 1982)	Limited. Informational asymmetries and principal-agent problems are inherent in dynamic competition. Imperfect competition enables firms to set prices and wages
Maximising behaviour	No. Human action includes entrepreneurial <i>discovery</i> of new ends-means frameworks and not just allocation of known scarce means among known competing ends	Yes. All individuals independently optimise expected utility (or profit) subject to constraints. They engage in purely calculative economising activity	Yes. As for perfect-markets programme (though the objects of choice and the constraints might differ)
Anti-monopoly	No. Market dominance and high profits are not in themselves a cause for concern. An industry will be more highly concentrated the greater the difference in participants' alertness to profit opportunities	No. Genuine monopolies are infrequent, short-lived and eliminated by free entry, and they have a limited effect. Firms do not earn supernormal profits in equilibrium	Yes. Monopoly may significantly affect relative prices or quantities and may greatly distort the allocation and utilisation of resources (relative to that in competitive equilibrium)

	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
Structural uncertainty	Yes. Neither policy-makers nor economic agents have full knowledge of the structure of the future, not even in a probabilistic sense (i.e. they are radically ignorant and do not possess rational expectations)	No. Economic agents tend to have full and relevant (probabilistic) knowledge of market data. Information bearing on prices and qualities can be acquired at an economically optimal level. People always hold rational expectations	No. Highly informed governments can improve on competitive market outcomes through appropriate mixes of taxes, subsidies and regulations (Stiglitz 1987: 14). Information bearing on prices and qualities can be acquired at an economically optimal level
Superior plan-coordinating properties of markets	Yes. The unhampered market coordinates the economic plans of individuals better than any other feasible resource allocation system	No. The market renders consistent all prices and quantities so that all prices clear all markets. The market is more efficient than any other resource allocation system	No. The relative efficiency of a market economy and a centrally planned system depends on the costs of operating each system in any particular case (Grossman and Stiglitz 1976)
Spontaneous origin of money	Yes. Money is a spontaneous by-product of the market economy. It is no one's invention	No. Money is a deliberate artefact of government policy	No. As for perfect-markets programme
Subjective costs and benefits	Yes. 'The opportunity cost involved in choice cannot be observed and objectified and, more importantly, it cannot be measured in such a way as to allow comparisons over wholly different choice settings' (Buchanan 1973: 15)	No. Costs and benefits can be objectively measured. Observed prices of inputs are good approximations of the opportunity cost of using them (Reder 1982: 15)	No. Costs and benefits can be objectively measured
Non-neutrality of monetary and fiscal policy	No. Both monetary policy and fiscal policy can have real effects. No tax is ever neutral	Yes. Monetary policy and fiscal policy have no systematic effects on real variables (Sargent and Wallace 1975)	No. Both monetary policy and fiscal policy can have real effects
Path dependence	Yes. History and the sequencing of policies matter. Market processes take place in real time, which is asymmetric and unidirectional	No. History has no tangible effect on competition. 'Time is fully analogized to space' so that time is reversible (O'Driscoll and Rizzo 1996: 53)	No in general (except for new Keynesian theories of hysteresis and theories of technological lock-in)

	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
<i>Heuristics:</i>			
When economic activities appear dis-coordinated, find the source of the relevant failure in communication among participants (e.g. distorted price signals)	Yes	No	No
Treat the market as an open-ended, dynamic competitive process and treat arbitrage as a disequilibrium activity in real-time	Yes. Avoid basing policy analysis upon closed 'single-exit' models of competition, which yield a determinate equilibrium	No. Continually push the use of equilibrium ('single-exit') theorising in policy analysis to the limits of its applicability. Analyse observable market phenomena with reference to equilibrium states	No. As for perfect-markets programme. Employ temporary equilibrium modelling techniques. Treat arbitrage as an equilibrium activity
Recognise that entrepreneurship is the engine of economic development	Yes	No	No
Pay attention to the impact of policy on (the determinants of) people's alertness, the incentives for entrepreneurial discovery and the pattern of entrepreneurial activity	Yes	No	No
Develop policy analysis on the assumption that individual economic agents only optimise subject to constraints	No	Yes	Yes
Emphasise the subjectivity of costs and benefits in policy analysis, and reject aggregate notions of welfare and social cost-benefit analysis for assessing policies	Yes	No	No
Recognise the severe knowledge problems of centralised decision-making and the bounded rationality of government planners	Yes	No	No
Apply market-process analysis to the institutional design of the monetary regime	Yes	No	No

	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
Recognise that nominal money supply changes (with money demand unchanged) frustrate market coordination because they distort relative price formation and entrepreneurial plans and have real and unsustainable effects on the intertemporal structure of heterogeneous capital	Yes (Mises 1971; Hayek 1935)	No	No
Determine how to conduct fiscal affairs so as to give maximum scope to market forces in the private sector	Yes	Yes	No
Prescribe, for each 'market failure', the specific government interventions that will lead to a Pareto improvement and identify the parameters (e.g. supply and demand elasticities) that determine the optimal corrective policy	No. Seek to identify the sources of alleged 'market failures' in gaps in the institutional framework, especially the private property rights system, and eliminate any loopholes identified	No. Treat alleged 'market failures' as highly suspect and as being most likely the result of the failure of policy analysis to consider all the relevant variables (Toumanoff 1984: 529)	Yes
Emphasise obtaining empirical and historical information about the problem situation and investigate the historical, path-dependent process that gives rise to the policy issue(s)	Yes	No (except for the monetarists' emphasis on historical facts)	No
Judge the performance of economic systems and arrangements by how quickly and accurately they discover and reduce the waste and discoordination associated with disequilibrium situations	Yes	No. Assess economic systems and arrangements according to the standard of Pareto efficiency	No. Assess economic systems and arrangements according to the standard of 'constrained' Pareto efficiency (thereby taking into account the absence of complete markets and imperfections of information) (Stiglitz 1987)

Austrians are interested in understanding how the real world ticks:

Austrians do take seriously the most pervasive and dependable facts about empirical reality. These include human purpose and other introspectively known realities, scarcity and the necessity of choice, the phenomenon of diminishing marginal returns, and the fragmentation of knowledge. They include other features of the real world that unavoidably restrict atomistic competition to being the exception rather than the rule and that accord entrepreneurs a large role in the working of markets. ... Austrians are guilty less often than the neoclassicals of what P. T. Bauer (1987) aptly diagnosed as the 'disregard of reality'. (Yeager 1997a)

Although proponents of the market-process view usually assume that there is a role for government in the establishment and maintenance of an institutional framework within which markets operate, they do not presume that specific government intervention is necessarily required to correct market outcomes. As mentioned earlier, the taxonomy of policy approaches is more analytical than sociological. As a consequence, the classification scheme does not provide an exact one-to-one correspondence with established schools of economic thought. For example, the market-process view encompasses almost all Austrian economists except Rothbard and Salerno. In addition, some Chicago economists (e.g. Demsetz and Brozen) and some members of the mainstream neoclassical school (e.g. Fisher 1983; 1987) have also, whether consciously or not, been market-process theorists of a sort (though Demsetz can also be interpreted as straddling the fence between a perfectmarkets and a market-process view of the world).

Comparing 'stylised' policy prescriptions of the three policy programmes Table 6.2 identifies selected 'stylised' policy prescriptions that indicate the flavour of policy recommendations forthcoming from the MPP and the perfect-markets and market-failure policy programmes. There is some risk in this sort of presentation, however. It must be emphasised that these 'stylised' prescriptions do not represent general policy rules of the MPP. Nor do they form part of the heuristics of the MPP. They are tentative implications only.

Austrian economics is, first and foremost, a way of looking at the world and of framing questions. It is only secondarily a system of conclusions about market economies which, when combined with some very commonly held value judgments, produces a free-market 'advocacy'. (Rizzo 1992a)

In practice, the specific policy solution that proponents of any policy programme will actually recommend for any particular policy problem will depend upon the application of their respective hard-core assumptions and heuristics to the empirical details of the case and their conjectures about the range of possible effects of alternative policies. Indeed, policy-makers may be able to draw upon empirical work (including econometric research) that provides insights on ‘the magnitude of the effect of, x, [say, some quantifiable policy variable] on the whole complex phenomenon, y, at some specific point in time’ (Rizzo 1978). In addition, it should be noted that these policy recommendations are not value neutral and that they are imbued with implicit value judgements about the ends that are worth pursuing. An interesting observation to emerge from a comparison of Tables 6.1 and 6.2 is that the specifications of the perfect-markets and market-failure policy programmes are very similar to each other and both different to the MPP, and yet the ‘stylised’ policy prescriptions derived from the perfectmarkets programme and the MPP are similar to each other and both different to the market-failure policy prescriptions. In a somewhat different context, Paqué provides a clue to the answer to these questions:

In the Austrian view of the market as a ceaseless process of discovery and information dissemination, there is no single individual and no board of directors who knows how the relative scarcity of goods will look like in the future. Granted this premise, it must be unwise to put the power of resource allocation into the hands of some committee, even if it is a democratically elected one. Hence setting up a stable institutional framework and letting the simultaneous adjustment of all private economic agents proceed on its own is the best way to ensure the most rapid growth of knowledge. Tight prior equilibrium theorizing along Chicago lines has similar consequences for policy making: If markets can rightly be assumed to work efficiently (including the efficient use of available information), there is simply no rationale for government intervention apart from setting up a stable institutional framework (including an unambiguous definition of property rights). (Paqué 1985) Alternatively, it could be argued that, in order to be consistent in their position, Chicago economists ought to be open to the prospect of a high degree of government intervention in markets because the assumptions of perfect competition are frequently violated. Their perfect-markets, equilibriumclearing perspective would tend to imply that government is needed to bring the unregulated market closer to the conditions of perfect competition. For example, Friedman’s prescriptions on competition policy cannot be derived from his economic analysis of monopoly. According to this line of argument, the free-market

prescriptions of the Chicago school are not so much the result of their economics as of their political philosophy (classical liberalism). Only Austrian market-process economics is capable of deriving market-oriented policy prescriptions analytically.

Table 6.2 Comparison of selected 'stylised' policy prescriptions

Abolish patent rights to allow new competition in innovation	Mixed. Yes – Rothbard (1993: 652–660); Mises straddled the fence (1966: 661–662)	No	No
Prescribe government intervention (i.e. specific regulatory commands) in order: (a) to control the use of monopoly power; and (b) to prohibit 'anticompetitive' behaviour	No. Do away with antitrust policy, and abandon governmental control of mergers, takeovers and trade practices (Armentano 1990; O'Driscoll and Rizzo 1996: 130–159)	No in general (except for 'natural monopolies' if their services are regarded as essential and their market power is sizeable (Friedman 1982: 29)). Seek an efficiency explanation for why the behaviour in question is not really anticompetitive	Yes
Eliminate all tariffs, import quotas and restrictions on exports	Yes	Yes	No
Remove all international capital controls (i.e. controls on inward and outward foreign investment, whether direct, portfolio or equity investment)	Yes	Yes	No
Remove direct regulation of exchange rates	Mixed. Yes – Mises (1966: 800–803), Rothbard, Salerno; no – White	Yes	No
Establish a sound monetary framework (as the role of a central authority)	Mixed. Yes – Mises, early Hayek, Kirzner; no – later Hayek, Rothbard, White, Selgin	Yes (Friedman 1982)	Yes

<i>'Stylised' policy prescriptions</i>	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
Choose stability in the general level of output prices as the principal objective of government's monetary policy	No. Stabilise M (Rothbard 1993: 850). Stabilise MV (Hayek 1935). Hold MV constant and let changes in Q cause inverse changes in P, preferably under a 'free banking' monetary regime (Selgin 1995; 1997)	Yes	Mixed. Yes (menu cost theory); no – focus on raising employment through expansionary monetary policy (e.g. staggered wage contract theory)
Avoid using government spending and taxation as countercyclical policy tools that try to correct alleged 'market failures'	Yes	Yes	No
Reduce as much as possible the level of government expenditure, and maintain fiscal balance (i.e. a balanced budget)	Yes	Yes	No
Broaden the tax base as much as possible, and reduce and flatten tax rates	Yes. Use income not consumption as the tax base. Emphasise reducing tax rates more than flattening them	Yes	No
Privatise state-owned enterprises or go for partial privatisation (and divestment of assets, sale of rights, share sales, etc.) where full privatisation is not possible	Yes	Yes in general (except 'natural monopolies' under some circumstances)	No. Advocate state ownership and/or control where economies of scale are so important that monopoly is inevitable
Separate funding from provision of state health and educational services, and encourage private sector crowd-in	Yes	Yes	No
Tighten eligibility requirements and reduce levels of governmental social transfer payments (e.g. unemployment benefits)	Yes	Yes	No

<i>'Stylised' policy prescriptions</i>	<i>Market-process programme</i>	<i>Perfect-markets programme</i>	<i>Market-failure programme</i>
Favour market-oriented policies within a stable, rule-bound institutional framework that maximises individual freedom and the scope for voluntary mutually beneficial exchange	Yes	Yes	No
Establish and maintain a minimal regulatory and welfare state, and avoid supplanting private arrangements with centrally determined solutions	Yes (except for Rothbardians who are anarcho-capitalists)	Yes	No. There is a large role for the state in the provision of 'public goods', regulation and redistribution (Stiglitz 1994)
If the policy goal is to enhance plan coordination, do not reduce the rewards for successful entrepreneurship (by taxing pure profit) or increase the penalties for entrepreneurial error and failure	Yes	No	No
Look initially to spontaneous ordering processes to address perceived problems with market outcomes (e.g. rely upon entrepreneurial-discovery processes to handle alleged externalities)	Yes	No	No
In general, if government action is thought necessary to address 'externalities', choose market-based regulation by rules (e.g. the creation of water rights) over specific regulatory commands, taxes or subsidies	Yes (Mises 1966: 654–660; but not Arnold 1995)	Yes	No
Remove government controls on inputs, outputs, wages and prices, quantities and qualities	Yes	Yes	No
Remove government-imposed barriers to new entry in all industries (including statutory monopolies and occupational licensing laws)	Yes	Yes	No

Chapter Seven - The Practice of Entrepreneurship and Entrepreneurial Strategies

7.1 The Practice of Entrepreneurship

The entrepreneurial requires different management from the existing. But like the existing it requires systematic, organized, purposeful management. And while the ground rules are the same for every entrepreneurial organization, the existing business, the public-service institution, and the new venture present different challenges, have different problems, and have to guard against different degenerative tendencies. There is need also for individual entrepreneurs to face up to decisions regarding their own roles and their own commitments.

7.1.1 Entrepreneurial Management

Entrepreneurship is based on the same principles, whether the entrepreneur is an existing large institution or an individual starting his or her new venture singlehanded. It makes little or no difference whether the entrepreneur is a business or a nonbusiness public-service organization, nor even whether the entrepreneur is a governmental or nongovernmental institution. The rules are pretty much the same, the things that work and those that don't are pretty much the same, and so are the kinds of innovation and where to look for them. In every case there is a discipline we might call Entrepreneurial Management. Yet the existing business faces different problems, limitations, and constraints from the solo entrepreneur, and it needs to learn different things. The existing business, to oversimplify, knows how to manage but needs to learn how to be an entrepreneur and how to innovate. The nonbusiness public-service institution, too, faces different problems, has different learning needs, and is prone to making different mistakes. And the new venture needs to learn how to be an entrepreneur and how to innovate, but above all, it needs to learn how to manage. For each of these three:

- the existing business
- the public-service institution
- the new venture

a specific guide to the practice of entrepreneurship must be developed.

7.1.2 (I) The Entrepreneurial Business

“Big businesses don’t innovate,” says the conventional wisdom. This sounds plausible enough. True, the new, major innovations of this century did not come out of the old, large businesses of their time. The railroads did not spawn the automobile or the truck; they did not even try. And though the automobile companies did try (Ford and General Motors both pioneered in aviation and aerospace), all of today’s large aircraft and aviation companies have evolved out of separate new ventures. Similarly, today’s giants of the pharmaceutical industry are, in the main, companies that were small or nonexistent fifty years ago when the first modern drugs were developed. Every one of the giants of the electrical industry—General Electric, Westinghouse, and RCA in the United States; Siemens and Philips on the Continent; Toshiba in Japan—rushed into computers in the 1950s. Not one was successful. The field is dominated by IBM, a company that was barely middle-sized and most definitely not high-tech forty years ago.

Specifically, entrepreneurial management requires policies and practices in four major areas. First, the organization must be made receptive to innovation and willing to perceive change as an opportunity rather than a threat. It must be organized to do the hard work of the entrepreneur. Policies and practices are needed to create the entrepreneurial climate. Second, systematic measurement or at least appraisal of a company’s performance as entrepreneur and innovator is mandatory, as well as built-in learning to improve performance. Third, entrepreneurial management requires specific practices pertaining to organizational structure, to stalling and managing, and to compensation, incentives, and rewards. Fourth, there are some “don’t’s”: things not to do in entrepreneurial management.

II - ENTREPRENEURIAL POLICIES

A Latin poet called the human being “*rerum novarum cupidus* (greedy for new things).” Entrepreneurial management must make each manager of the existing business “*rerum novarum cupidus*.” “How can we overcome the resistance to innovation in the existing organization?” is a question commonly asked by executives. Even if we knew the answer, it would still be the wrong question. The right one is: “How can we make the organization receptive to innovation, want innovation, reach for it, work for it?” When innovation is perceived by the organization as something that goes against the grain, as swimming against the current, if

not as a heroic achievement, there will be no innovation. Innovation must be part and parcel of the ordinary, the norm, if not routine. This requires specific policies. First, innovation, rather than holding on to what already exists, must be made attractive and beneficial to managers. There must be clear understanding throughout the organization that innovation is the best means to preserve and perpetuate that organization, and that it is the foundation for the individual manager's job security and success. Second, the importance of the need for innovation and the dimensions of its time frame must be both defined and spelled out. And finally, there needs to be an innovation plan, with specific objectives laid out.

1. There is only one way to make innovation attractive to managers: a systematic policy of abandoning whatever is outworn, obsolete, no longer productive, as well as the mistakes, failures, and misdirections of effort. Every three years or so, the enterprise must put every single product, process, technology, market, distributive channel, not to mention every single internal staff activity, on trial for its life. To allow it to innovate, a business has to be able to free its best performers for the challenges of innovation. Equally it has to be able to devote financial resources to innovation. It will not be able to do either unless it organizes itself to slough off alike the successes of the past, the failures, and especially the "near-misses," the things that "should have worked" but didn't. If executives know that it is company policy to abandon, then they will be motivated to look for the new, to encourage entrepreneurship, and will accept the need to become entrepreneurial themselves. This is the first step—a form of organizational hygiene.

2. The second step, the second policy needed to make an existing business "greedy for new things," is to face up to the fact that all existing products, services, markets, distributive channels, processes, technologies, have limited—and usually short—health and life expectancies. An analysis of the life cycle of existing products, services, and so on has become popular since the 1970s. Some examples are the strategy concepts advocated by the Boston Consulting group; the books on strategy by the Harvard Business School professor Michael Porter; and so-called portfolio management.* In the strategies that have been widely advertised these last ten years, especially portfolio management, the findings of such analysis constitute an action program by themselves. The idea that bright young people straight from business school and equipped only with sharp analytical tools could crunch out of their computer life-and-death

decisions about businesses, products, and markets is pure quackery, to be blunt. It is a challenge to all the knowledge that can be found in a given company, and all the experience. It will—and should—provoke dissent. The action that follows from classifying this or that product as “today’s breadwinner” is a risk-taking decision. And so is what to do with the product that is on the point of becoming “yesterday’s breadwinner,” or with an “unjustified specialty,” or with an “investment in managerial ego.”

3. The Business X-Ray furnishes the information needed to define how much innovation a given business requires, in what areas, and within what time frame. The best and simplest approach to this was developed by Michael J. Kami as a member of the Entrepreneurship Seminar at the New York University Graduate Business School in the 1950s. Kami first applied his approach to IBM, where he served as head of business planning; and then, in the early 1960s, to Xerox, where he served for several years in a similar capacity. In this approach a company lists each of its products or services, but also the markets each serves and the distributive channels it uses, in order to estimate their position on the product life cycle. To be sure, some innovative efforts will do better than anyone expects, but others will do much less well. And everything takes longer than we hope or estimate; everything also requires more effort. Finally, the one thing certain about any major innovative effort is that there are going to be last-minute hitches and last-minute delays. To demand innovative efforts which, if everything goes according to plan, yield three times the minimum results needed is only elementary precaution.

4. Systematic abandonment; the Business X-Ray of the existing business, its products, its services, its markets, its technologies; and the definition of innovation gap and innovation need—these together enable a company to formulate an entrepreneurial plan with objectives for innovation and deadlines. Such a plan ensures that the innovation budget is adequate. And—the most important result of all—it determines how many people are needed, with what abilities and capacities. Only when people with proven performance capacity have been assigned to a project, supplied with the tools, the money, and the information they need to do the work, and given clear and unambiguous deadlines—only then do we have a plan. Until then, we have “good intentions,” and what those are good for, everybody knows.

III - ENTREPRENEURIAL PRACTICES

Entrepreneurship in the existing business also requires managerial practices.

1. First among these, and the simplest, is focusing managerial vision on opportunity. People see what is presented to them; what is not presented tends to be overlooked. And what is presented to most managers are “problems”—especially in the areas where performance falls below expectations—which means that managers tend not to see the opportunities. They are simply not being presented with them. Management, even in small companies, usually get a report on operating performance once a month. The first page of this report always lists the areas in which performance has fallen below budget, in which there is a “shortfall,” in which there is a “problem.” At the monthly management meeting, everyone then goes to work on the so-called problems. By the time the meeting adjourns for lunch, the whole morning has been taken up with the discussion of those problems. Of course, problems have to be paid attention to, taken seriously, and tackled. But if they are the only thing that is being discussed, opportunities will die of neglect. In businesses that want to create receptivity to entrepreneurship, special care is therefore taken that the opportunities are also attended to. In these companies, the operating report has two “first pages”: the traditional one lists the problems; the other one lists all the areas in which performance is better than expected, budgeted, or planned for.

2. This company follows a second practice to generate an entrepreneurial spirit throughout its entire management group. Every six months it holds a two-day management meeting for all executives in charge of divisions, markets, and major product lines—a group of about forty or fifty people. The first morning is set aside for reports to the entire group from three or four executives whose units have done exceptionally well as entrepreneurs and innovators during the past year.

3. A third practice, and one that is particularly important in the large company, is a session—informal but scheduled and well prepared—in which a member of the top management group sits down with the junior people from research, engineering, manufacturing, marketing, accounting and so on.

IV - MEASURING INNOVATIVE PERFORMANCE

For a business to be receptive to entrepreneurship, innovative performance must be included among the measures by which that business controls itself. Only if we assess the entrepreneurial

performance of a business will entrepreneurship become action. Human beings tend to behave as they are expected to. In the normal assessments of a business, innovative performance is conspicuous by its absence. Yet it is not particularly difficult to build measurement, or at least judgment, of entrepreneurial and innovative performance into the controls of the business.

1. The first step builds into each innovative project feedback from results to expectations. This indicates the quality and reliability of both our innovative plans and our innovative efforts.
2. The next step is to develop a systematic review of innovative efforts all together. Every few years an entrepreneurial management looks at all the innovative efforts of the business.
3. Finally, entrepreneurial management entails judging the company's total innovative performance against the company's innovative objectives, against its performance and standing in the market, and against its performance as a business all- together.

V - STRUCTURES

Policies, practices, and measurements make possible entrepreneurship and innovation. They remove or reduce possible impediments. They create the proper attitude and provide the proper tools. But innovation is done by people. And people work within a structure. For the existing business to be capable of innovation, it has to create a structure that allows people to be entrepreneurial. It has to devise relationships that center on entrepreneurship. It has to make sure that its rewards and incentives, its compensation, personnel decisions, and policies, all reward the right entrepreneurial behavior and do not penalize it.

1. This means, first, that the entrepreneurial, the new, has to be organized separately from the old and existing. Whenever we have tried to make an existing unit the carrier of the entrepreneurial project, we have failed. This is particularly true, of course, in the large business, but it is true in medium-sized businesses as well, and even in small businesses.
2. This means also that there has to be a special locus for the new venture within the organization, and it has to be pretty high up. Even though the new project, by virtue of its current size, revenues, and markets, does not rank with existing products, somebody in top management must have the specific assignment to work on tomorrow as an entrepreneur and innovator.

3. There is another reason why a new, innovative effort is best set up separately: to keep away from it the burdens it cannot yet carry. Both the investment in a new product line and its returns should, for instance, not be included in the traditional return-on-investment analysis until the product line has been on the market for a number of years.

4. As implied in discussing individual compensation, the returns on innovation will be quite different from those of the existing business and will have to be measured differently. To say, “We expect all our businesses to show at least a fifteen percent pre-tax return each year and ten percent annual growth” may make sense for existing businesses and existing products.

5. The final structural requirement for entrepreneurship in the existing business is that a person or a component group should be held clearly accountable. In the “middle-sized growth companies” mentioned earlier, this is usually the primary responsibility of the chief executive officer (CEO). In large companies, it probably is more likely a designated and very senior member of the top management group. In smaller businesses, this executive in charge of entrepreneurship and innovation may well carry other responsibilities as well.

VI - STAFFING

In successful entrepreneurial businesses, nobody seems to worry whether a given person is likely to do a good job of development or not. People of all kinds of temperaments and backgrounds apparently do equally well. Any young engineer in 3M who comes to top management with an idea that makes sense is expected to take on its development. Equally, there is no reason to worry where the successful entrepreneur will end up. To be sure, there are some people who only want to work on new projects and never want to run anything. When most English families still had nannies, many did not want to stay after “their” baby got to the stage when it began to walk and talk—in other words, when it was no longer a baby. But many were perfectly content to stay on and did not find it difficult to look after a much older child. The people who do not want to be anything but entrepreneurs are unlikely to be in the employ of an existing business to begin with, and even more unlikely to have been successful in it. And the people who do well as entrepreneurs in an existing business have, as a rule, proved themselves earlier as managers in the same organization.

Staffing decisions in the entrepreneurial business are made like any other decision about people and jobs. Of course, they are risk-taking decisions: decisions about people always are. Of course, they have to be made carefully and conscientiously. And they have to be made the correct way. First, the assignment must be thought through; then one considers a number of people; then one checks carefully their performance records; and finally one checks out each of the candidates with a few people for whom he or she has worked. But all this applies to every decision that puts a person into a job. And in the entrepreneurial company, the batting average in people-decisions is the same for entrepreneurs as it is for other managerial and professional people.

VII - THE DONT'S

There are some things the entrepreneurial management of an existing business should not do.

1. The most important caveat is not to mix managerial units and entrepreneurial ones. Do not ever put the entrepreneurial into the existing managerial component. Do not make innovation an objective for people charged with running, exploiting, optimizing what already exists.
2. Innovative efforts that take the existing business out of its own field are rarely successful. Innovation had better not be “diversification.” Whatever the benefits of diversification, it does not mix with entrepreneurship and innovation.
3. Finally, it is almost always futile to avoid making one’s own business entrepreneurial by “buying in,” that is, by acquiring small entrepreneurial ventures. Acquisitions rarely work unless the company that does the acquiring is willing and able within a fairly short time to furnish management to the acquisition.

7.1.3 (I) Entrepreneurship in the Service Institution

Public-service institutions such as government agencies, labor unions, churches, universities, and schools, hospitals, community and charitable organizations, professional and trade associations and the like, need to be entrepreneurial and innovative fully as much as any business does. Indeed, they may need it more. The rapid changes in today’s society, technology, and economy are simultaneously an even greater threat to them and an even greater opportunity. Yet public-service institutions find it far more difficult to innovate than even the most “bureaucratic” company. The “existing” seems to be even more of an obstacle. To be sure, every service

institution likes to get bigger. In the absence of a profit test, size is the one criterion of success for a service institution, and growth a goal in itself. And then, of course, there is always so much more that needs to be done. But stopping what has “always been done” and doing something new are equally anathema to service institutions, or at least excruciatingly painful to them.

There are three main reasons why the existing enterprise presents so much more of an obstacle to innovation in the public-service institution than it does in the typical business enterprise.

1. First, the public-service institution is based on a “budget” rather than being paid out of its results. It is paid for its efforts and out of funds somebody else has earned, whether the taxpayer, the donors of a charitable organization, or the company for which a personnel department or the marketing services staff work. The more efforts the public service institution engages in, the greater its budget will be.

2. Second, a service institution is dependent on a multitude of constituents. In a business that sells its products on the market, one constituent, the consumer, eventually overrides all the others. A business needs only a very small share of a small market to be successful.

3. The most important reason, however, is that public-service institutions exist after all to “do good.” This means that they tend to see their mission as a moral absolute rather than as economic and subject to a cost/benefit calculus.

II - ENTREPRENEURIAL POLICIES

These are all American examples, I fully realize. Doubtless, similar examples are to be found in Europe or Japan. But I hope that these cases, despite their limitations, will suffice to demonstrate the entrepreneurial policies needed in the public-service institution to make it capable of innovation.

1. First, the public-service institution needs a clear definition of its mission.

2. The public-service institution needs a realistic statement of goals.

3. Failure to achieve objectives should be considered an indication that the objective is wrong, or at least defined wrongly.

4. Finally, public-service institutions need to build into their policies and practices the constant search for innovative opportunity.

III - THE NEED TO INNOVATE

The public-service sector, both the governmental one and the nongovernmental but not-forprofit one, has grown faster during this century than the private sector—maybe three to five times as fast. The growth has been especially fast since World War II. To some extent, this growth has been excessive. Wherever publicservice activities can be converted into profit-making enterprises, they should be so converted. This applies not only to the kind of municipal services the city of Lincoln, Nebraska, now “privatizes.” The move from non-profit to profit has already gone very far in the American hospital. I expect it to become a stampede in professional and graduate education. To subsidize the highest earners in developed society, the holders of advanced professional degrees, can hardly be justified. A central economic problem of developed societies during the next twenty or thirty years is surely going to be capital formation; only in Japan is it still adequate for the economy’s needs. We therefore can ill afford to have activities conducted as “non-profit,” that is, as activities that devour capital rather than form it, if they can be organized as activities that form capital, as activities that make a profit. But still the great bulk of the activities that are being discharged in and by public-service institutions will remain public-service activities, and will neither disappear nor be transformed. Consequently, they have to be made producing and productive. Public-service institutions will have to learn to be innovators, to manage themselves entrepreneurially. To achieve this, public-service institutions will have to learn to look upon social, technological, economic, and demographic shifts as opportunities in a period of rapid change in all these areas. Otherwise, they will become obstacles.

7.1.4 The New Venture

For the existing enterprise, whether business or public-service institution, the controlling word in the term “entrepreneurial management” is “entrepreneurial.” For the new venture, it is “management.” In the existing business, it is the existing that is the main obstacle to entrepreneurship. In the new venture, it is its absence. The new venture has an idea. It may have a product or a service. It may even have sales, and sometimes quite a substantial volume of them. It surely has costs. And it may have revenues and even profits. What it does not have is a

“business,” a viable, operating, organized “present” in which people know where they are going, what they are supposed to do, and what the results are or should be. But unless a new venture develops into a new business and makes sure of being “managed,” it will not survive no matter how brilliant the entrepreneurial idea, how much money it attracts, how good its products, nor even how great the demand for them. Refusal to accept these facts destroyed every single venture started by the nineteenth century’s greatest inventor, Thomas Edison. Edison’s ambition was to be a successful businessman and the head of a big company. He should have succeeded, for he was a superb business planner. He knew exactly how an electric power company had to be set up to exploit his invention of the light bulb. He knew exactly how to get all the money he could possibly need for his ventures. His products were immediate successes and the demand for them practically insatiable. But Edison remained an entrepreneur; or rather, he thought that “managing” meant being the boss. He refused to build a management team. And so every one of his four or five companies collapsed ignominiously once it got to middle size, and was saved only by booting Edison himself out and replacing him with professional management.

Entrepreneurial management in the new venture has four requirements: It requires, first, a focus on the market. It requires, second, financial foresight, and especially planning for cash flow and capital needs ahead. It requires, third, building a top management team long before the new venture actually needs one and long before it can actually afford one. And finally, it requires of the founding entrepreneur a decision in respect to his or her own role, area of work, and relationships.

I - THE NEED FOR MARKET FOCUS

A common explanation for the failure of a new venture to live up to its promise or even to survive at all is: “We were doing fine until these other people came and took our market away from us. We don’t really understand it. What they offered wasn’t so very different from what we had.” Or one hears: “We were doing all right, but these other people started selling to customers we’d never even heard of and all of a sudden they had the market.” When a new venture does succeed, more often than not it is in a market other than the one it was originally intended to serve, with products or services not quite those with which it had set out, bought in large part by customers it did not even think of when it started, and used for a host of purposes besides the ones for which the products were first designed. If a new venture does not anticipate this,

organizing itself to take advantage of the unexpected and unseen markets; if it is not totally market-focused, if not market-driven, then it will succeed only in creating an opportunity for a competitor. There are exceptions, to be sure. A product designed for one specific use, especially if scientific or technical, often stays with the market and the end use for which it was designed. But not always. Even a prescription drug designed for a specific ailment and tested for it sometimes ends up being used for some other quite different ailment. One example is a compound that is effectively used in the treatment of stomach ulcers. Or a drug designed primarily for the treatment of human beings may find its major market in veterinary medicine.

II - FINANCIAL FORESIGHT

Lack of market focus is typically a disease of the “neo-natal,” the infant new venture. It is the most serious affliction of the new venture in its early stages—and one that can permanently stunt even those that survive. The lack of adequate financial focus and of the right financial policies is, by contrast, the greatest threat to the new venture in the next stage of its growth. It is, above all, a threat to the rapidly growing new venture. The more successful a new venture is, the more dangerous the lack of financial foresight.

III - BUILDING A TOP MANAGEMENT TEAM

The new venture has successfully established itself in the right market and has then successfully found the financial structure and the financial system it needs. Nonetheless, a few years later it is still prone to run into a serious crisis. Just when it appears to be on the threshold of becoming an “adult”—a successful, established, going concern—it gets into trouble nobody seems to understand. The products are first-rate, the prospects are excellent, and yet the business simply cannot grow. Neither profitability nor quality, nor any of the other major areas performs. The reason is always the same: a lack of top management. The business has outgrown being managed by one person, or even two people, and it now needs a management team at the top. If it does not have one already in place at the time, it is very late—in fact, usually too late. The best one can then hope is that the business will survive. But it is likely to be permanently crippled or to suffer scars that will bleed for many years to come. Morale has been shattered and employees throughout the company are disillusioned and cynical. And the people who founded the business and built it almost always end up on the outside, embittered and disenchanted. The remedy is

simple: To build a top management team before the venture reaches the point where it must have one. Teams cannot be formed overnight. They require long periods before they can function. Teams are based on mutual trust and mutual understanding, and this takes years to build up. In my experience, three years is about the minimum. But the small and growing new venture cannot afford a top management team; it cannot sustain half a dozen people with big titles and corresponding salaries. In fact, in the small and growing business, a very small number of people do everything as it comes along.

IV- “WHERE CAN I CONTRIBUTE?”

Building a top management team may be the single most important step toward entrepreneurial management in the new venture. It is only the first step, however, for the founders themselves, who then have to think through what their own future is to be. As a new venture develops and grows, the roles and relationships of the original entrepreneurs inexorably change. If the founders refuse to accept this, they will stunt the business and may even destroy it.

THE NEED FOR OUTSIDE ADVICE

These last cases point up an important factor for the entrepreneur in the new and growing venture, the need for independent, objective outside advice. The growing new venture may not need a formal board of directors. Moreover, the typical board of directors very often does not provide the advice and counsel the founder needs. But the founder does need people with whom he can discuss basic decisions and to whom he listens. Such people are rarely to be found within the enterprise. Somebody has to challenge the founder's appraisal of the needs of the venture, and of his own personal strengths. Someone who is not a part of the problem has to ask questions, to review decisions and, above all, to push constantly to have the long-term survival needs of the new venture satisfied by building in the market focus, supplying financial foresight, and creating a functioning top management team. This is the final requirement of entrepreneurial management in the new venture.

7.2 ENTREPRENEURIAL STRATEGIES

Just as entrepreneurship requires entrepreneurial management, that is, practices and policies within the enterprise, so it requires practices and policies outside, in the marketplace. It requires entrepreneurial strategies.

7.2.1 “Fustest with the Mostest”

Yet they are important; they are distinct; and they are different. There are four specifically entrepreneurial strategies:

1. Being “Fustest with the Mostest”;
2. “Hitting Them Where They Ain’t”;
3. Finding and occupying a specialized “ecological niche”;
4. Changing the economic characteristics of a product, a market, or an industry.

These four strategies are not mutually exclusive. One and the same entrepreneur often combines two, sometimes even elements of three, in one strategy. They are also not always sharply differentiated; the same strategy might, for instance, be classified as “Hitting Them Where They Ain’t” or as “Finding and occupying a specialized ‘ecological niche.’” Still, each of these four has its prerequisites. Each fits certain kinds of innovation and does not fit others. Each requires specific behavior on the part of the entrepreneur. Finally, each has its own limitations and carries its own risks.

I - BEING “FUSTEST WITH THE MOSTEST”

Being “Fustest with the Mostest” was how a Confederate cavalry general in America’s Civil War explained consistently winning his battles. In this strategy the entrepreneur aims at leadership, if not at dominance of a new market or a new industry. Being “Fustest with the Mostest” does not necessarily aim at creating a big business right away, though often this is indeed the aim. But it aims from the start at a permanent leadership position. Being “Fustest with the Mostest” is the approach that many people consider the entrepreneurial strategy par excellence. Indeed, if one were to go by the popular books on entrepreneurs,* one would conclude that being “Fustest with the Mostest” is the only entrepreneurial strategy—and a good many entrepreneurs, especially the high-tech ones, seem to be of the same opinion. They are wrong, however. To be sure, a good

many entrepreneurs have indeed chosen this strategy. Yet being “Fustest with the Mostest” is not even the dominant entrepreneurial strategy, let alone the one with the lowest risk or the highest success ratio. On the contrary, of all entrepreneurial strategies it is the greatest gamble. And it is unforgiving, making no allowances for mistakes and permitting no second chance. But if successful, being “Fustest with the Mostest” is highly rewarding.

7.2.2 “Hit Them Where They Ain’t”

Two completely different entrepreneurial strategies were summed up by another battle-winning Confederate general in America’s Civil War, who said: “Hit Them Where They Ain’t.” They might be called creative imitation and entrepreneurial judo, respectively.

A/ CREATIVE IMITATION

Creative imitation* is clearly a contradiction in terms. What is creative must surely be original. And if there is one thing imitation is not, it is “original.” Yet the term fits. It describes a strategy that is “imitation” in its substance. What the entrepreneur does is something somebody else has already done. But it is “creative” because the entrepreneur applying the strategy of “creative imitation” understands what the innovation represents better than the people who made it and who innovated.

B/ ENTREPRENEURIAL JUDO

In 1947, Bell Laboratories invented the transistor. It was at once realized that the transistor was going to replace the vacuum tube, especially in consumer electronics such as the radio and the brandnew television set. Everybody knew this; but nobody did anything about it. The leading manufacturers—at that time they were all Americans—began to study the transistor and to make plans for conversion to the transistor “sometime around 1970.” Till then, they proclaimed, the transistor “would not be ready.” Sony was practically unknown outside of Japan and was not even in consumer electronics at the time. But Akio Morita, Sony’s president, read about the transistor in the newspapers. As a result, he went to the United States and bought a license for the new transistor from Bell Labs for a ridiculous sum, all of \$25,000. Two years later, Sony brought out the first portable transistor radio, which weighed less than one-fifth of comparable vacuum tube radios on the market, and cost less than onethird. Three years later, Sony had the market for

cheap radios in the United States; and live years later, the Japanese had captured the radio market all over the world. Of course, this is a classic case of the rejection of the unexpected success.

7.2.3 Ecological Niches

The “ecological niche” strategy aims at control. The strategies discussed earlier aim at positioning an enterprise in a large market or a major industry. The ecological niche strategy aims at obtaining a practical monopoly in a small area. The first three strategies are competitive strategies. The ecological niche strategy aims at making its successful practitioners immune to competition and unlikely to be challenged. Successful practitioners of “Fustest with the Mostest,” creative imitation, and entrepreneurial judo become big companies, highly visible if not household words. Successful practitioners of the ecological niche take the cash and let the credit go. They wallow in their anonymity. Indeed, in the most successful of the ecological niche strategies, the whole point is to be so inconspicuous, despite the product’s being essential to a process, that no one is likely to try to compete. There are three distinct niche strategies, each with its own requirements, its own limitations, and its own risks:

- the toll-gate strategy;
- the specialty skill strategy; and
- the specialty market strategy.

I. THE TOLL-GATE STRATEGY

All that potential competitors could possibly do, therefore, would have been to knock down the price for everybody, without deriving much benefit for themselves. A very similar toll-gate position has been occupied for many years by a medium-sized company which, fifty or sixty years ago, developed a blowout protector for oil wells. The cost of drilling an oil well may run into many millions. One blowout will destroy the entire well and everything that has been invested in it. The blowout protector, which safeguards the well while being drilled, is thus cheap insurance, no matter what its price. Again, the total market is so limited as to make it unattractive for any would-be competitor. Lowering the price of blowout protectors, which constitute maybe 1 percent of the total cost of a deep well, could not possibly stimulate anyone to drill more wells. Competition could only degrade the price without increasing the demand. Another example of a toll-gate strategy is Dewey & Almy—now a division of W. R. Grace. This company developed a compound to seal tin cans in the 1930s. The seal is an essential ingredient of the can: if a can

goes bad, it can cause catastrophic damage. One death from one case of botulism in a can can easily destroy a food packer. A can-sealing compound that offers protection against spoilage is therefore cheap at any price. And yet the cost of sealing—a fraction of a cent at best—is so insignificant to both the cost of the total can and the risk of spoilage that nobody is much concerned about it. What matters is performance, not cost. Again, the total market, while larger than that for enzymes in cataract operations or for blowout protectors, is still a limited one. And lowering the price for can-sealing compound is quite unlikely to increase the demand by a single can. The toll-gate position is thus in many ways the most desirable position a company can occupy. But it has stringent requirements. The product has to be essential to a process. The risk of not using it—the risk of losing an eye, losing an oil well, or spoilage in a tin can—must be infinitely greater than the cost of the product. The market must be so limited that whoever occupies it first preempts it. It must be a true “ecological niche” which one species fills completely, and which at the same time is small and discreet enough not to attract rivals.

I. THE SPECIALTY SKILL

Unlike the toll-gate companies, theirs is a fairly large niche, yet it is still unique. It was obtained by developing high skill at a very early time. A. O. Smith developed what today would be called “automation” in making automobile frames during and shortly after World War I. The electrical system which Bosch in Germany designed for Mercedes staff cars around 1911 was so far advanced that it was put into general use even in luxury automobiles only after World War II. Delco in Dayton, Ohio, developed the self-starter before becoming a part of General Motors, that is, before 1914. Such specialized skills put these companies so far ahead in their field that it was hardly worth anybody’s while to try to challenge them. They had become the “standard.” Specialty skill niches are by no means confined to manufacturing. Within the last ten years a few private trading firms, most of them in Vienna, Austria, have built a similar niche in what used to be called “barter” and is now called “counter-trade”: taking goods from a developing importing country, Bulgarian tobacco or Brazilian-made irrigation pumps, in payment for locomotives, machinery, or pharmaceuticals exported by a company in a developed country. And much earlier, an enterprising German attained such a hold on one specialty skill niche that guidebooks for tourists are still called by his name, “Baedeker.” As these cases show, timing is of the essence in establishing a specialty skill niche. It has to be done at the very beginning of a new industry, a

new custom, a new market, a new trend. Karl Baedeker published his first guidebook in 1828, as soon as the first steamships on the Rhine opened tourist travel to the middle classes. He then had the field virtually to himself until World War I made German books unacceptable in Western countries. The counter-traders of Vienna started around 1960, when such trade was still the rare exception, largely confined to the smaller countries of the Soviet Bloc (which explains why they are concentrated in Austria). Ten years later, when hard currencies had become scarce all through the Third World, they had honed their skills and become the “specialists.” To attain a specialty niche always requires something new, something added, something that is genuine innovation. There were guidebooks for travelers before Baedeker, but they confined themselves to the cultural scene—churches, sights, and so on. For practical details—the hotels, the tariff of the horse-drawn cabs, the distances, and the proper amount to tip—the traveling English milord relied on a professional, the courier. But the middle class had no courier, and that was Baedeker’s opportunity. Once he had learned what information the traveler needed, how to get at it and to present it (the format he established is still the one many guidebooks follow), it would not have paid anyone to duplicate Baedeker’s investment and build a competing organization. In the early stages of a major new development, the specialty skill niche offers an exceptional opportunity. Examples abound. For many, many years there were only two companies in the United States making airplane propellers, for instance. Both had been started before World War I. A specialty skill niche is rarely found by accident. In every single case, it results from a systematic survey of innovative opportunities. In every single case, the entrepreneur looks for the place where a specialty skill can be developed and can give a new enterprise a unique controlling position. Robert Bosch spent years studying the new automotive field to position his new company where it could immediately establish itself as the leader. Hamilton Propeller, for many years the leading airplane propeller manufacturer in the United States, was the result of a systematic search by its founder in the early days of powered flight. Baedeker made several attempts to start a service for the tourist before he decided on the guidebook that then bore his name and made him famous. The first point, therefore, is that in the early stages of a new industry, a new market, or a new major trend, there is the opportunity to search systematically for the specialty skill opportunity—and then there is usually time to develop a unique skill. The second point is that the specialty skill niche does require a skill that is both unique and different.

The early automobile pioneers were, without exception, mechanics. They knew a great deal about machinery, about metals and about engines. But electricity was alien to them.

It required theoretical knowledge which they neither possessed nor knew how to acquire. There were other publishers in Baedeker's time, but a guidebook that required on-the-spot gathering of an enormous amount of detailed information, constant inspection, and a staff of traveling auditors was not within their purview. "Counter-trade" is neither trading nor banking. The business that establishes itself in a specialty skill niche is therefore unlikely to be threatened by its customers or by its suppliers. Neither of them really wants to get into something that is so alien in skill and in temperament. Thirdly, a business occupying a specialty skill niche must constantly work on improving its own skill. It has to stay ahead. Indeed, it has to make itself constantly obsolete. The automobile companies in the early days used to complain that Delco in Dayton, and Bosch in Stuttgart, were pushing them. They turned out lighting systems that were far ahead of the ordinary automobile, ahead of what the automobile manufacturers of the times thought the customer needed, wanted, or could pay for, ahead very often of what the automobile manufacturer knew how to assemble. While the specialty skill niche has unique advantages, it also has severe limitations. One is that it inflicts tunnel-vision on its occupants. In order to maintain themselves in their controlling position, they have to learn to look neither right nor left, but directly ahead at their narrow area, their specialized field. Airplane electronics were not too different from automobile electronics in the early stages. Yet the automobile electricians—Delco, Bosch, and Lucas—are not leaders in airplane electronics. They did not even see the field and made no attempt to get into it. A second, serious limitation is that the occupant of a specialty skill niche is usually dependent on somebody else to bring his product or service to market. It becomes a component. The strength of the automobile electrical firms is that the customer does not know that they exist. But this is of course also their weakness. If the British automobile industry goes down, so does Lucas. A. O. Smith prospered making automotive frames until the energy crisis. Then American automobile manufacturers began to switch to cars without frames. These cars are substantially more expensive than cars with frames, but they weigh less and therefore burn less fuel. A. O. Smith could do nothing to reverse the adverse trend. Finally, the greatest danger to the specialty niche manufacturer is for the specialty to cease being a specialty and to become universal. The niche that the Viennese counter-traders now occupy was occupied in the 1920s and 1930s by foreign exchange traders who were mostly Swiss. Bankers of those

days, having grown up before World War I, still believed that currencies ought to be stable. And when currencies became unstable, when there were blocked currencies around, currencies with different exchange rates for different purposes, and other such monstrosities, the bankers did not even want to handle the business. They were only too happy to let the specialists in Switzerland do what they thought was a dirty job.

II. THE SPECIALTY MARKET

The major difference between the specialty skill niche and the specialty market niche is that the former is built around a product or service and the latter around specialized knowledge of a market. Otherwise, they are similar. Two medium-sized companies, one in northern England and one in Denmark, supply the great majority of the automated baking ovens for cookies and crackers bought in the non-Communist world. For many decades, two companies—the two earliest travel agents, Thomas Cook in Europe and American Express in the United States—had a Dractical monopoly on travelers checks.

There is, I am told, nothing very difficult or particularly technical about baking ovens. There are literally dozens of companies around that could make them just as well as those two firms in England and Denmark. But these two know the market: they know every single major baker, and every single major baker knows them. The market is just not big enough or attractive enough to try to compete with these two, as long as they remain satisfactory. Until 1929 the cosmetics market was a “specialty market,” a market of the upper middle class. But then during the Depression it exploded into a genuine mass market. It also split into two segments: a prestige segment, with high prices, specialty distribution, and specialty packaging; and popular-priced, mass brands sold in every outlet including the supermarket, the variety store, and the drugstore. Within a few short years, the specialty market dominated by Coty had disappeared. But Coty could not make up its mind whether to try to become one of the mass marketers in cosmetics or one of the luxury producers. It tried to stay in a market that no longer existed, and has been drifting ever since.

7.2.4 Changing Values and Characteristics

The product or service it carries may well have been around a long time—in our first example, the postal service, it was almost two thousand years old. But the strategy converts this old,

established product or service into something new. It changes its utility, its value, its economic characteristics. While physically there is no change, economically there is something different and new. All the strategies to be discussed in this chapter have one thing in common. They create a customer—and that is the ultimate purpose of a business, indeed, of economic activity. But they do so in four different ways:

- by creating utility;
- by pricing;
- by adaptation to the customer's social and economic reality;
- by delivering what represents true value to the customer.

I. CREATING CUSTOMER UTILITY

English schoolboys used to be taught that Rowland Hill “invented” the postal service in 1836. That is nonsense, of course. The Rome of the Caesars had an excellent service, with fast couriers carrying mail on regular schedules to the furthest corners of the Empire. A thousand years later, in 1521, the German emperor Charles V, in true Renaissance fashion, went back to Classical Rome and gave a monopoly on carrying mail in the imperial domains to the princely family of Thurn and Taxis. Their generous campaign contributions had enabled him to bribe enough German Electors to win the imperial crown—and the princes of Thurn and Taxis still provided the postal service in many parts of Germany as late as 1866, as stamp collectors know. By the middle of the seventeenth century, every European country had organized a postal service on the German model and so had, a hundred years later, the American colonies. Indeed, all the great letter-writers of the Western tradition, from Cicero to Madame de Sévigné, Lord Chesterfield, and Voltaire, wrote and posted their letters long before Rowland Hill “invented” the postal service. Yet Hill did indeed create what we would now call “mail.” He contributed no new technology and not one new “thing,” nothing that could conceivably have been patented. But mail had always been paid for by the addressee, with the fee computed according to distance and weight. This made it both expensive and slow. Every letter had to be brought to a post office to be weighed. Hill proposed that postage should be uniform within Great Britain regardless of distance; that it be prepaid; and that the fee be paid by affixing the kind of stamp that had been used for many years to pay other fees and taxes. Overnight, mail became easy and convenient; indeed, letters could now be dropped into a collection box. Immediately, also, mail became absurdly cheap. The letter that had earlier cost a shilling or more— and a shilling was as much as

a craftsman earned in a day—now cost only a penny. The volume was no longer limited. In short, “mail” was born. Hill created utility. In fact, the reduction in the cost of mailing a letter, although 80 percent or more, was secondary. The main effect was to make using the mails convenient for everybody and available to everybody. Letters no longer had to be confined to “epistles.” The tailor could now use the mail to send a bill.

II. PRICING

For many years, the best known American face in the world was that of King Gillette, which graced the wrapper of every Gillette razor blade sold anyplace in the world. And millions of men all over the world used a Gillette razor blade every morning. King Gillette did not invent the safety razor; dozens of them were patented in the closing decades of the nineteenth century. Until 1860 or 1870, only a very small number of men, the aristocracy and a few professionals and merchants, had to take care of their facial hair, and they could well afford a barber. Then, suddenly, large numbers of men, tradesmen, shopkeepers, clerks, had to look “respectable.” Few of them could handle a straight razor or felt comfortable with so dangerous a tool, but visits to the barber were expensive, and worse, time-consuming. Many inventors designed a “do-it-yourself” safety razor, yet none could sell it. A visit to the barber cost ten cents and the cheapest safety razor cost five dollars—an enormous sum in those days when a dollar a day was a good wage. Gillette’s safety razor was no better than many others, and it was a good deal more expensive to produce. But Gillette did not “sell” the razor. He practically gave it away by pricing it at fifty-five cents retail or twenty cents wholesale, not much more than one-fifth of its manufacturing cost. But he designed it so that it could use only his patented blades. These cost him less than one cent apiece to make: he sold them for five cents.

III. THE CUSTOMER’S REALITY

The worldwide leadership of the American General Electric Company (G.E.) in large steam turbines is based on G.E.’s having thought through, in the years before World War I, what its customers’ realities were. Steam turbines, unlike the piston-driven steam engines which they replaced in the generation of electric power, are complex, requiring a high degree of engineering in their design, and skill in building and fitting them. This the individual electric power company simply cannot supply. It buys a major steam turbine maybe every five or ten years when it builds

a new power station. Yet the skill has to be kept in being all the time. The manufacturer, therefore, has to set up and maintain a massive consulting organization.

But, as G.E. soon found out, the customer cannot pay for consulting services. Under American law, the state public utility commissions would have to allow such an expenditure. In the opinion of the commissions, however, the companies should have been able to do this work themselves. G.E. also found that it could not add to the price of the steam turbine the cost of the consulting services which its customers needed. Again, the public utility commissions would not have accepted it. But while a steam turbine has a very long life, it needs a new set of blades fairly often, maybe every five to seven years, and these blades have to come from the maker of the original turbine. G.E. built up the world's foremost consulting engineering organization on electric power stations—though it was careful not to call this consulting engineering but “apparatus sales”—for which it did not charge. Its steam turbines were no more expensive than those of its competitors. But it put the added cost of the consulting organization plus a substantial profit into the price it charged for replacement blades. Within ten years all the other manufacturers of steam turbines had caught on and switched to the same system. But by then G.E. had world market leadership. Much earlier, during the 1840s, a similar design of product and process to fit customer realities led to the invention of installment buying. Cyrus McCormick was one of many Americans who built a harvesting machine—the need was obvious. And he found, as had the other inventors of similar machines, that he could not sell his product. The farmer did not have the purchasing power. That the machine would earn back what it cost within two or three seasons, everybody knew and accepted, but there was no banker then who would have lent the American farmer the money to buy a machine. McCormick offered installments, to be paid out of the savings the harvester produced over the ensuing three years. The farmer could now afford to buy the machine—and he did so. Manufacturers are wont to talk of the “irrational customer” (as do economists, psychologists, and moralists). But there are no “irrational customers.” As an old saying has it, “There are only lazy manufacturers.” The customer has to be assumed to be rational. His or her reality, however, is usually quite different from that of the manufacturer. The rules and regulations of public utility commissions may appear to make no sense and be purely arbitrary. For the power companies that have to operate under them, they are realities nonetheless. The American farmer may have been a better credit risk than American bankers of 1840 thought. But it was a fact that American banks of that period did not advance

money to farmers to purchase equipment. The innovative strategy consists in accepting that these realities are not extraneous to the product, but are, in fact, the product as far as the customer is concerned. Whatever customers buy has to fit their realities, or it is of no use to them.

IV. DELIVERING VALUE TO THE CUSTOMER

The last of these innovative strategies delivers what is “value” to the customer rather than what is “product” to the manufacturer. It is actually only one step beyond the strategy of accepting the customer’s reality as part of the product and part of what the customer buys and pays for. A medium-sized company in America’s Midwest supplies more than half of all the special lubricant needed for very large earth-moving and hauling machines: the bulldozers and draglines used by contractors building highways; the heavy equipment used to remove the overlay from strip mines; the heavy trucks used to haul coal out of coal mines; and so on. This company is in competition with some of the largest oil companies, which can mobilize whole battalions of lubrication specialists. It competes by not selling lubricating oil at all. Instead, it sells what is, in effect, insurance. What is “value” to the contractor is not lubrication: it is operating the equipment. Every hour the contractor loses because this or that piece of heavy equipment cannot operate costs him infinitely more than he spends on lubricants during an entire year. In all these activities there is a heavy penalty for contractors who miss their deadlines—and they can only get the contract by calculating the deadline as finely as possible and racing against the clock. What the Midwestern lubricant maker does is to offer contractors an analysis of the maintenance needs of their equipment. Then it offers them a maintenance program with an annual subscription price, and guarantees the subscribers that their heavy equipment will not be shut down for more than a given number of hours per year because of lubrication problems. Needless to say, the program always prescribes the manufacturer’s lubricant. But this is not what contractors buy. They are buying troublefree operations, which are extremely valuable to them.

The final example—one that might be called “moving from product to system”—is that of Herman Miller, the American furniture maker in Zeeland, Michigan. The company first became well known as the manufacturer of one of the early modern designs, the Eames chair. Then, when every other manufacturer began to turn out designer chairs, Herman Miller moved into making and selling whole offices and work stations for hospitals, both with considerable success. Finally, when the “office of the future” began to come in, Herman Miller founded a Facilities

Management Institute that does not even sell furniture or equipment, but advises companies on office layout and equipment needed for the best work flow, high productivity, high employee morale, all at low cost. What Herman Miller is doing is defining “value” for the customer. It is telling the customer, “You may pay for furniture, but you are buying work, morale, productivity. And this is what you should therefore be paying for.”

These examples are likely to be considered obvious. Surely, anybody applying a little intelligence would have come up with these and similar strategies? But the father of systematic economics, David Ricardo, is believed to have said once, “Profits are not made by differential cleverness, but by differential stupidity.” The strategies work, not because they are clever, but because most suppliers—of goods as well as of services, businesses as well as public-service institutions—do not think. They work precisely because they are so “obvious.” Why, then, are they so rare? For, as these examples show, anyone who asks the question, What does the customer really buy? will win the race. In fact, it is not even a race since nobody else is running. What explains this? One reason is the economists and their concept of “value.” Every economics book points out that customers do not buy a “product,” but what the product does for them. And then, every economics book promptly drops consideration of everything except the “price” for the product, a “price” defined as what the customer pays to take possession or ownership of a thing or a service. What the product does for the customer is never mentioned again. Unfortunately, suppliers, whether of products or of services, tend to follow the economists. It is meaningful to say that “product A costs X dollars.” It is meaningful to say that “we have to get Y dollars for the product to cover our own costs of production and have enough left over to cover the cost of capital, and thereby to show an adequate profit.” But it makes no sense at all to conclude, “... and therefore the customer has to pay the lump sum of Y dollars in cash for each piece of product A he buys.” Rather, the argument should go as follows: “What the customer pays for each piece of the product has to work out as Y dollars for us. But how the customer pays depends on what makes the most sense to him. It depends on what the product does for the customer. It depends on what fits his reality. It depends on what the customer sees as ‘value.’” Price in itself is not “pricing,” and it is not “value.” It was this insight that gave King Gillette a virtual monopoly on the shaving market for almost forty years; it also enabled the tiny Haloid Company to become the multibillion-dollar Xerox Company in ten years, and it gave General Electric world leadership in steam turbines. In every single case, these companies became

exceedingly profitable. But they earned their profitability. They were paid for giving their customers satisfaction, for giving their customers what the customers wanted to buy, in other words, for giving their customers their money's worth. "But this is nothing but elementary marketing," most readers will protest, and they are right. It is nothing but elementary marketing. To start out with the customer's utility, with what the customer buys, with what the realities of the customer are and what the customer's values are—this is what marketing is all about. But why, after forty years of preaching Marketing, teaching Marketing, professing Marketing, so few suppliers are willing to follow, I cannot explain. The fact remains that so far, anyone who is willing to use marketing as the basis for strategy is likely to acquire leadership in an industry or a market fast and almost without risk.