

## Theories of Entrepreneurship: A Critical Overview

Ahmet TIRYAKI\*

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**Abstract:** When the concept of entrepreneurship is used in economics, the purpose of analysis is mainly to explain (i) how the market system works and (ii) the various kinds of income -especially profit- and their relation with entrepreneurship. Entrepreneurship is always linked with profit, and the main emphasis of this paper will be on the part played by the entrepreneur in economic process. Even though there are several approaches to entrepreneurship, to profit and to functions that the entrepreneurs provide in the market process, this paper will focus on the ideas of the Neoclassical Theory (in general, the ideas of Marshall), the Schumpeterian approach, and mainly the Neo-Austrian theories of entrepreneurship (Kirzner). All three approaches are critically analysed and both strong sides and shortcomings are introduced in terms of their implications and their applications in regulation of monopolies.

**Keywords:** Entrepreneurship, competition, profit, regulation.

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### Giriřimcilik Teorileri: Kritik Bir Bakıř

**Özet:** Bu makale genel olarak girişimcilik ve girişimcilik ve kar ilişkisi konusunda klasik olarak genelleştirilebilecek temel üç görüşün temsilcilerinin bu konulardaki görüşlerini kritik bir yaklaşımla analiz etme işini yapar. Bu analiz yapılırken temel görüşlerin temsilcileri olarak Marshall, Schumpeter ve Kirzner alınarak bunların görüşleri, bu görüşlerin eleştirileri ve sonuç olarakta maket denetimi (regulation) olarak çıkarımlarının neler oldukları irdelenmektedir.

**Anahtar Kelimeler:** Giriřimcilik, rekabet, kar, düzenleme.

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**“What separated the modern schools of economic theory from one another was largely nothing more than a matter of language and style.”**

**L.V. Mises**

### INTRODUCTION

For any economic theory, it is important to focus on what questions the theory is designed to answer and what tools are being used to answer them. When the concept of entrepreneurship is used in economics, the purpose of analysis is mainly to explain (i) how the market system works and (ii) the various kinds of income -especially profit- and their relation with entrepreneurship. Entrepreneurship is always linked with profit, and the main emphasis of this paper will be on the part played by the entrepreneur in economic process.

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\* Yard. Doç. Dr. Anadolu Üniversitesi, İİBF, İktisat Bölümü. - ahmettiriyaki@anadolu.edu.tr

Even though there are several approaches to entrepreneurship, to profit and to functions that the entrepreneurs provide in the market process, this paper will focus on the ideas of the Neoclassical Theory (in general, the ideas of Marshall), the Schumpeterian approach, and mainly the Neo-Austrian theories of entrepreneurship (Kirzner).

In analysing entrepreneurship, Marshall mainly tries to explain how markets reach to equilibrium under the assumption of perfect competition and does not give each individual manufacturer a specific role in terms of innovation or change. Many small size firms compete, and, in equilibrium, there is no excess profit is earned by each firm. The model fails to explain profit and how changes and innovations occur in a capitalist economy and ignores the role of creative entrepreneurs' effects on economic development.

Schumpeter rejects the equilibrium analysis and he believes that human economic development is the history of continuous creative destructions by entrepreneurs. The entrepreneur is an innovator, not an imitator in the production and, as an innovator, naturally he is monopolist. Since economic progress comes from innovations, innovator monopolist should be protected and entrepreneurship should be encouraged.

Kirzner's entrepreneur is an alert arbitrageur and competition between alert entrepreneurs helps the market clearing process. Economic agents have different information and knowledge and this difference creates opportunities for entrepreneurs to exploit them and cause market to go to equilibrium. He believes that in the markets the tendency towards a single price is continually interrupted- but continually resumed.

In this paper, each of the above indicated approaches to entrepreneurship will be critically analysed and at the end some implications-regarding regulations- will be discussed.

## **1. MARSHALLIAN APPROACH TO ENTREPRENEURSHIP**

The Neo-classical theory and thereby the Marshallian analysis tries to explain equilibrium conditions in the markets under the assumptions of perfect knowledge and information, perfect competition (existence of many firms), existence of homogenous goods, and free entry and exit.

Marshall's main concern and at the same time goal is to show that markets clear under the perfect competition assumptions and there are no excess profit opportunities and hence there is no exploitation of labor in production process since everyone earns his marginal contribution to production and national income. However, while he analyses zero profit equilibrium conditions, at the same time he has to explain without profit incentives how change and progress occurs and what leads producers to innovate or develop

new production methods and techniques. To answer this question, Marshall uses small changes (innovations) in the market process by many small competitors and confusingly indicates that large scale production is essential for economic progress and economic innovation.

Marshall<sup>1</sup> stresses the cooperative relationship between capital and labor based on the principle of partnership. The producer obtains his dominant position in the production process due to his superior managerial abilities. Hence this superior ability is the reason that producers get more of the income: their contribution to national income is greater than the labor.

According to Loasby (1982), Marshall analyzes the normal running business as entrepreneurship, but he recognizes that some businessmen are much more enterprising than others. He does not make this distinction because he does not want to further analyse the difference between a stationary state and the evolving economy and "...he regards the formal analysis of a stationary state as a potentially misleading guide to the study of economic progress." (p.235)

Thus, in the Marshallian analysis, the firms have to organize their production and marketing functions in an evolving economy which is an environment of uncertainty and change. Producers face the uncertainties in various ways:

- Estimating the pattern of consumer preferences and technologies available to meet them;
- Anticipating the actions of rivals;
- Developing techniques to respond to changes in consumer preferences, to the emergence of new technologies or to new entrant firms.

Marshall attempts to deal with all of these issues. In Marshall's analysis (1947, p.297), the successful entrepreneur who produces for the market, as a merchant and as an organizer of the production has true knowledge of the things in his own trade. He has the ability (i) of forecasting the movements (changes) of production and consumer preferences, (ii) of seeing new opportunities for supplying new goods or services that either will meet the demand or improve the plan of producing an old commodity and most importantly being able to take risk. Loasby (1982) calls the Marshallian competition as a "Hayekian discovery process"

Loasby states that, according to Marshall, the advantage of having many firms in an industry was not that they should facilitate perfect competition, but they should be different so that they would discover different things. Thus, the formal assumptions of perfect competition (firms are similar and

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<sup>1</sup> See Marz (1991)

many, they produce homogenous goods and are price takers) destroy Marshall's analysis.

In summary, Marshall tries to explain economic progress- like Austrian economists (Kirzner) try to explain today, in terms of the numberless small improvements in productivity and in the range of quality of products available. In Kirzner's analysis of entrepreneurship, the disequilibrium is corrected by alert entrepreneurs who produce and exchange, but the emphasis is on the exchange opportunities and progress comes mainly from this part. Unlike Schumpeterian analysis, in Marshallian theory the progress does not depend on "great man" but it does depend on many men.

There are important problems in Marshall's analysis that create controversy in his own model:

- The manufacturer producing for the general market who is supposed to be represented by the perfectly competitive firm of the standard theory and in this, there is no introduction of neither new products or new methods, Marshall states that "...a characteristic task of modern manufacturer is that of creating new wants by showing people something which they have never thought of having before; but which they want to have as soon as the notion is suggested to them." (p.280) In this statement, Marshall is contradicting with his competitive market theory by indicating that creating new products and technologies the entrepreneur will have monopoly power and earn monopoly rents in that market unless everybody in the market have same technology and will produce same good as efficiently at the same time and start to sell at the same time.
- Marshall gives role to his entrepreneur to anticipate the actions of his rivals. If the market is perfectly competitive and for each firms the market price is given, then there is no need for each firm to anticipate the actions of the other firms since their production decisions does not affect the market price.
- In Marshall's treatment of economies of scale, the economies themselves are related to knowledge and change: the law of increasing returns implies that an increase in inputs (L, K) improves the organization of the production, which increases the efficiency of these inputs. Thus the advantage of large scale is that it leads to innovation, not only in technology but also in products. If this is true, then the accumulation of capital leads concentration in the market and this leads existence of imperfect market competition that we in reality have.
- In Marshallian analysis, manufacturers produce for the market getting zero profits but it is not clear what stimulates these people to be producers instead of -say- labor. Thus there is no explanation for profit:

Entrepreneurship and profit disappear from theory which formally excludes exchanges." (Loasby, 1982, p.240)

As a result, we see that Marshallian analysis has its own controversies to explain equilibrium conditions and is not able to explain the market process that gives accurate explanations about the role of entrepreneur and how profit is explained.

## **2. SCHUMPETER: CREATIVE DESTRUCTION**

Schumpeter (1991) defines entrepreneur as someone who establishes a new business to produce a new product or to make an old product in a new way. In his work, the entrepreneur takes the center stage of socioeconomic development. He takes the role of socioeconomic leader since he has the ability to decide, to direct, to push matters through. The Schumpeterian entrepreneur differs from imitators in applying new methods of production on the market, in opening up new markets. This creative ability differences gives entrepreneur a chance of accumulation of a surplus but this eroded as imitators appear in the market using same methods. Thus, the temporary monopoly profits made by the entrepreneur shows the dynamic of the capitalist system and also show that each cycle of innovations by entrepreneurs is the main cause of business cycles.

He sharply differentiates himself from Marshallian-Neoclassical theories of economic development and growth. While, in the Marshallian analysis, small contributions from a very large number of modest entrepreneurs lead economic progress, Schumpeter's entrepreneur plays the role of a revolutionary in creation of new production functions and methods. Thus, entrepreneurs create disequilibrium and this creative destruction is possible only under capitalistic system. He states that "Capitalism...is by nature a form or method of economic change and ...never could be stationary." (1942, p.82) As a result, unlike Marshall and Kirzner, he believes that due to capitalist system's dynamic nature the neoclassical general equilibrium model could never apply to capitalism. Schumpeter does not define those who are imitators or those who simply recognize and respond to the new situations as entrepreneurs unless their responses consist of forming new firms to create new innovations. In this sense, his definition of entrepreneurship and explanation of economic progress in a capitalistic system differ from the Kirzner's explanation as we will see below. Schumpeter would not see Kirzner's alert arbitrageur as an entrepreneur.

In contrast to Marshall, Schumpeter's analysis progress does depend on the "great man" and as an innovator, economic and social leader the entrepreneur by definition is a monopolist. Since the entrepreneur is the engine of the economic progress in the capitalist system, monopolies should

be encouraged to lead to new innovations. The entrepreneurship ability is scarce and the business of entrepreneurs is too risky. Since they undertake the economic activities that lie outside of the routine tasks and they do these under the social and economic resistant environments their activities should be encouraged, some protection should be provided and to reduce the risk they take. Entrepreneurial risk and uncertainty are reduced by large scale enterprise and restrictive practices such as patents.

Thus the reward of innovations and taking entrepreneurial risky activities is profit. The profit for Schumpeter is the result of innovation and also the inducement to innovation and only the capitalist system allows the successful entrepreneur to take profit. With his analysis unlike Marshall, Schumpeter is able to explain how the system works and where the profits come from.

There is some criticism against Schumpeter's creative destruction theory:

- Schumpeter puts all the responsibility of innovations on the shoulders of 'great man'. However, if innovations and the act of pushing them through commercially are carried out not by individuals, but by a generation, then the contrast between the leader and imitators irrelevant.
- What about those who have tried but have not succeeded?

Recently, in the U.S. and in Europe, some economists and legal authorities discuss whether Microsoft has broken anti-trust laws and try to answer whether it should be regulated. Economists mostly cite Schumpeter's idea about innovation and argue that Bill Gates is a Schumpeterian innovator and for destructive creation sense the Microsoft should not be tried. Marz, known for his research about Schumpeter, indicates that Schumpeter's innovator as an economic and social leader does not care much about economic profits and only joy he gets from being an innovator and being a server to his society. Marz (1991), states that "Schumpeter ...hardly denied that the process of accumulation is the ladder to social power and social prestige; but he thought the very mainspring of the exercise of the entrepreneurial function is the powerful will to assert economic leadership. The joy of carrying through innovations is the primary motive, the acquisition of social power a subsidiary to it." (p.24-25). To decide whether Bill Gates, in Schumpeterian sense, is an innovator, we have known his motivations. Even though as an individual who seeks his own interest before anybody else, Bill Gates as an innovator and monopolist should be protected and encouraged in Schumpeterian sense.

### 3. KIRZNER'S "ALERT" ENTREPRENEUR

While in Neoclassical analysis (Marshall) the main focus is the conditions necessary to sustain an equilibrium, and Schumpeter's focus was to explain the progress in capitalistic system by using innovator entrepreneur's destructive creation, Kirzner- representing the Neo-Austrian approach to entrepreneurship- focused on answering the question of whether a market economy works and, if it does so, what the process that leads the economy towards an equilibrium is. Kirzner claims that initially the economy is in disequilibrium and the competition among 'alert' entrepreneurs leads to equilibrium.

Unlike Neo-classical economists, Kirzner realizes that markets are not always clear, there is no perfectly informed representative agent and for change the entrepreneurs need incentives and this incentives comes from the difference among agents in terms of information and knowledge.

In order to explain his model, Kirzner benefits from Mises' "profit seeking and speculating entrepreneur" and Hayek' "mutual learning" ideas. For Mises (1949), the driving force of the market process and cause of market equilibration is the profit seeking and speculating entrepreneurs. Since each agent has different knowledge and information set in a real economy, every actor (agent) is an entrepreneur and speculator. Hayek (1948) does not directly emphasize the role of entrepreneur in the market process but he states that the market process gives information about everyone's plans to every other person. He believes that there is tendency towards equilibrium, but this does not mean markets always reach to equilibrium. He has doubt whether the assumption of a perfect market where every event becomes known instantaneously to every member exists.

According to Kirzner (1997), The Neoclassical theory examines markets- abstracting from institutional detail- by focusing only on supply, demand and price and he goes on stating that "it explains in great detail the relationships that would prevail in markets that already do work; it is silent on the nature of the process that might generate those relationships." (p.13)

For Kirzner (1997): "The entrepreneur who 'sees' (discovers) a profit opportunity, is discovering the existence of a gain which had...not been seen by himself or by anybody else." (p.34-35) To Kirzner, profit opportunities stimulate entrepreneurship. Different from Schumpeter, the profit arises from arbitrage not from innovation. "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 realized. This permits the pure entrepreneur to buy something for less than he will be able to sell it for. His act of entrepreneurship consists in realizing the existence of market value that has

hitherto been overlooked." (p.34) Kirzner's entrepreneur does not cause destructive creation and his activities do not cause change. The alert entrepreneur realizes that a change has occurred and sees profit opportunities. An improvement in technique of production or a shift in preferences leads to change (disequilibrium) in a market that initially was in equilibrium. "... Entrepreneurial discovery which enables decentralized decision-makers to recognize when present decisions can be improved upon and to anticipate future changes in the decisions being made by others. Movements in prices, production methods, choices of outputs, and resource owner incomes generated by entrepreneurial discovery tend to reveal where current allocation patterns are faulty, and stimulate changes in the corrective direction." (p.11) However, in his analysis there is no explanation of why a change has occurred and who or what forces caused that change.

There is no representative agent in his theory and agents are not homogenous in terms of ability, alertness and ability to reach information. In his analysis there are mainly two types of agents in the economy. Entrepreneurs, who are seeking to exploit opportunities, take the decisions and the bulk of the population do not take decisions. Entrepreneurs differ from the second group since they are alert and they have the ability to see that a change has occurred and there are exchange opportunities to exploit. As long as agents have different level information and level of knowledge, the limitations of non-entrepreneurs' knowledge provide an incentive and a profit opportunity for entrepreneurs. The difference in knowledge and information lead to differences in the valuation of a particular good.

According to Kirzner, an improvement in the technique of production or a shift in preferences leads to change (disequilibrium) in market initially there was equilibrium. If there is equilibrium in the market there is nothing for the entrepreneur to do and no exchange and profit opportunities for them since everybody will be able to carry out his initially determined exchange plans. But whenever the change has occurred, some planned activities will not be realized. In this point, the importance of the entrepreneur is understood, since they realize that the market is not in equilibrium due to either excess demand or excess supply and competition among entrepreneurs leads to equilibrium again.

Kirzner (1997) states that in an equilibrium world-the only world the Neo-classical model deals with because of perfect knowledge-there is no room "...for entrepreneurial discovery and creativity: the course of market events is foreordained by the data of market situation." (p.35) and for the system to create profit opportunities for entrepreneur there is need for an exogenous shock to system.

In Kirzner's model, unlike the Neo-classical theory, complete and perfect information is not assumed. If there is no market clearing price, those who



pay a higher price are unaware of the lower price that is available and thus the divergence between the two prices constitutes a pure profit opportunity for alert entrepreneurs. Entrepreneurial discovery, by seizing profit, is a powerful force pushing the two prices towards each other and eliminating the opportunity it initially offered. After explaining the entrepreneurial discovery process, he states that "the tendency towards a single price is continually interrupted-but continually resumed." (p.37)

The Kirzner's ideas about entrepreneurship can be summarized as:

- At any given moment economic agents are likely making errors as they try to estimate true present and future plans of other market participants.
- Such errors or miscalculations happen due to over optimism or over pessimism
- Entrepreneurial discovery process leads towards a single market price

#### **DISCUSSION ABOUT KIRZNER'S MARKET PROCESS MODEL**

The main concern I have regarding this explanation of market process is that since the focus is on exchange not in production then the following questions have to be answered:

- If producers are passive agents and they do not have the ability to cause change who or what factors cause improvements in the technique of production?
- Since the bulk of the population do not take decisions and they simply behave in a programmed way what is the cause of shift in preferences?
- Since in Stigler's theory of investment in information consumers' investment in information leads market clearing prices and market equilibrium, why do not rational agents behave same way and allow entrepreneurs to exploit the opportunities? It seems that consumers and producers behave as if they are programmed robots and they do not respond to incentives. Thus, the lack of respond to incentives gives opportunities to entrepreneurs to exploit them. If Hayek's learning process works properly, after one incidence when market price is made single, the non- entrepreneurs should learn the game and respond to incentives as if there are rational behaviour and rational expectations.

According to Loasby (1982), the main limitation of the model is that "Kirzner argues that new opportunities are continually being created by changes in the underlying data, but his model provides no incentives to produce such changes..."

If each entrepreneur had to consider the possibility that every other economic agent would attempt to exploit the opportunity which he can see, then the result might be gross over reaction." (p.244)

### **IMPLICATIONS REGARDING REGULATION OF MONOPOLIES**

Kirzner's and, thereby, the Neo-Austrian theory's definition of competition clearly differ from the traditional approach. For Kirzner, the definition of competition requires only the condition of 'freedom of entry' into market. "A single producer not protected against entry of potential competitors does not constitute a monopoly in the relevant sense." (p.59) Thus, the existence of freedom of entry not only forces the monopolist to increase efficiency in production by decreasing production costs, but also reduces the product prices. He indicates that "Competitive entry and the threat of competitive entry bring about the lowering of the product prices towards their lowest possible costs of production..." (p.48) Having many firms in the market for Kirzner is not the requirement to call that market as competitive. In the absence of entry barrier, entrance of only one or two new firms can make it the market competitive. Entrance of -say- only one firm indicates that either others could not see the profit opportunities in the market that this firm saw or the others correctly understand that no such profit opportunity exists.

As a result, the approach indicates that if there is no barrier to entry, the threat of new entries from potential entrants will force the monopolist to behave as if the market is competitive, there will be no excess profit and the threat will force the monopolist to reduce production costs. Since the outcome is close to the perfect competition outcome, and the dead weight loss is zero or close to zero, then there no room for government regulation.

Kirzner indicates that this new approach to regulation differ the Neo-Austrian theory from Neo-classical approach. However, Baumol' (1982), 'contestable markets' model indicates same results regarding monopoly regulations. Kirzner does not cite this model and keeps criticizing the Neo-classical theory. Another problem in this approach is that it implies if there is no regulation, in the long run, there will be many competitors in the market to bring profits to zero by exploiting given opportunities. If this were true, we would have seen non-regulated markets to be competitive in terms of number of producers and also marginal cost equal to prices. In reality, we see mostly oligopolies and certainly prices are higher than marginal cost in these markets.

#### 4. CONCLUSION

Theories of entrepreneurship are mainly designed to answer the questions: (i) how market system works and, (ii) what the relationship between entrepreneurship and profit is.

Marshallian theory which indicates the existence of perfect information and perfect competition assumptions fails to answer both questions accurately. The model indicates the non-existence of excess profits and does not distinguish entrepreneurship from routine production process.

The Schumpeterian analysis is the closest to the reality regarding the work of market system and creation of profit. However, he gives too much importance to individual innovations and ignores the effects of generations and previous failures to discover those innovations. He sees all innovations exogenous in this sense not endogenous to the system.

Kirzner's alert entrepreneur is an arbitrager and sees profit opportunities and exploits them. His model sees all non- entrepreneurs as programmed robots who do not respond to incentives and do not learn from past experiences. His model also fails to explain the above mentioned questions accurately. However, the model sees the mistakes of Marshallian analysis and tries to correct them.

Even though Kirzner sees his model's indication about competition and regulation, the model indicates same kind of policy implications for regulation of monopolies. Also, both Austrian and Neo-classical theories at the end reach market equilibrium. I think it would be appropriate to quote Mises' understanding for similarities of these two approaches: "What separated the modern schools of economic theory from one another was largely nothing more than a matter of language and style."

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