POLICY FORUMS

THE ENTREPRENEUR IN SOCIETY

Barry Maley ▪ Malcolm Fisher
Michael G. Porter ▪ Neville Kennard
Israel M. Kirzner

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Preface

Despite his pivotal role in the marketplace, the entrepreneur has not been accorded a major place in modern economic theory. Dominated by steady-state and equilibrium models, neo-classical economics occupies a world where change has been largely assumed away and where, as a consequence, there is little need for entrepreneurial activity. It is a tidy, pre-Heraclitean world, well-suited to mathematical formulae, but less relevant to the risk-taking businessman.

It is no surprise, then, that the contributors to this small volume have drawn independently on an economic tradition in which the role of entrepreneurship is fully recognised. The Austrian economists Schumpeter, von Mises and Hayek, all describe an economic world in flux. In this world where markets are created, new wants are satisfied and enterprises are born and die, entrepreneurship is vital. As a present-day member of the 'Austrian School', Israel Kirzner, points out in this volume, it is this dynamism, this 'ceaseless churning and agitation', this 'never-ending discovery process' which produces economic growth and which determines the success of the market.

Entrepreneurial activity cannot, then be designed; its fruits are, at best, unsure. For the producers and managers of public policy, entrepreneurship has uncertain value. In social cost-benefit analysis, the potential gains under a regime where entrepreneurial activity is encouraged and rewarded are usually assigned little weight. The result, as Malcolm Fisher observes, is that government controls abound.

The conditions under which entrepreneurship prospers are a major concern of all contributors to this book. There must be sufficient rewards to activate the entrepreneurial faculties. Kirzner notes that 'human beings tend to notice that which it is in their interest to notice.' Entrepreneurial alertness cannot be commanded nor, as Karl Popper put it, 'produced by rational methods'; it must be elicited by the anticipation of reward. Successful enterprise is the product of the diverse experimentation which results.

At a more mundane level, the would-be entrepreneur must have access to the resources necessary to realise his vision. Barry Maley argues that in a socialist society the class of potential entrepreneurs is limited because the average citizen does not have the means to accomplish his plans. Writing from his experience as a businessman, Neville Kennard comments on the difficulty faced by private companies in accumulating capital in a climate of high taxation.

Not surprisingly, government is a major determinant of the entrepreneurial climate. High taxation, government regulations and controls suppress the incentives to entrepreneurship. Intervention in the market distorts the signals about entrepreneurial opportunities. High inflation and frequent rule-changes increase uncertainty and dampen the preparedness to take risks. In the end, Kennard observes, it is not entrepreneurial activity as such which is difficult, but coping with the constraints imposed by government.

Professor Kirzner and Professor Michael Porter examine the entrepreneur under comparative incentive structures. Kirzner compares the performance of entrepreneurs under free and regulated market economies with managers in socialised economies. Porter undertakes a similar task in analysing the incentives facing entrepreneurs in public and private sector enterprises in the Australian economy. Both writers reach similar conclusions. Although there are imperfect incentive structures within state enterprises, there are no mechanisms to imitate the discovery process of the market. Change, particularly change threatening the extinction or radical restructuring of the enterprise, is beyond the scope of the state enterprise manager.

Emphasised throughout is the fragility of the entrepreneurial impulse. Keynes wrote:

> Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Only a little more than an expedition to the South Pole is it based on an exact calculation of benefits to come. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will falter and die . . . [1]

The danger of too much government, Maley concludes, is 'the extinction of enterprise in all fields, except perhaps the entrepreneurial arts of the courtier and the gaoler.'

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1. J.M. Keynes, *The General Theory of Employment, Interest and Money*, Macmillan, London, 1949, pp. 161-162

As befits a volume of a Policy Forum series, the papers reproduced in the body of this book were originally delivered at a seminar on entrepreneurship conducted by the Centre for Independent Studies in November 1981. Because of a failure of recording equipment, the discussion from that forum has been omitted from this volume. In its place, Israel Kirzner's influential paper, 'The Primacy of Entrepreneurial Discovery', referred to by several of the contributors, is included as an appendix.

Greg Lindsay

The Entrepreneurial Spirit

Barry Maley

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After graduating in Anthropology and Psychology from the University of Sydney, where he was awarded the Prize of the Anthropological Society of New South Wales, he joined the Commonwealth Public Service and was engaged primarily on a study of Cargo Cults in Papua New Guinea and the South-West Pacific. This was followed by an administrative career in the oil industry and the Universities of New England and Sydney. In 1961 he became National Secretary of the National Heart Foundation of Australia on its inception and for about two years was concurrently first Chief Executive Officer of the Winston Churchill Memorial Trust when it was established.

His published work is mainly in the sociology of the professions and organisation theory. He has been retained as consultant in organisational problems and management education by many private and public organisations. His current research interest is the institutional causes of organisational uncertainty.

The Entrepreneurial Spirit

Barry Maley

I. THE NATURE OF ENTREPRENEURSHIP

Ludwig von Mises has suggested[1] that there is an entrepreneurial element, in the sense of seeing and seizing opportunities for the achievement of personal goals, in all human activities. But in economic activities it is typically expressed in mediating between capital and labour in the innovation of economic production.

Israel Kirzner argues[2] that what especially distinguishes the entrepreneur from others engaged in economic production is his alertness to economic opportunity. Of course, in assessing the means of exploiting the opportunity he will calculate, but Kirzner wishes to separate this rational, calculating phase from the the initial insight that an opportunity is there. It is his imagination or 'seeing' that is the unique contribution of the entrepreneur. In this sense it is not something that can be regarded as a resource (as rationality and calculation can) to be deployed in decision-making in a production process; rather is it something prior to the production process and embedded in the decision to initiate the process. The entrepreneurial spirit is displayed, then, in the insight or alertness to the probability that a worthwhile, exploitable opportunity for economic production exists. As a spirit, or faculty, it is no doubt potential in all of us, but it is one which will only be **exercised** if certain conditions are met. We might express this in the form: A is alerted (by X) to opportunity B; the 'B' and 'X' in the proposition standing for certain psycho-social and institutional circumstances of interest to A that are capable of motivating A towards the innovation of economic production. In discussing this Kirzner concludes by emphasising 'the need for critical assessment, within any economic system of organisation, of the way in which the system permits the potential discoverers to identify their own personal interest with the successful discovery of socially desirable opportunities for change.'[3]

Kirzner does not attempt to answer the question of what constitutes the 'socially desirable', but, putting that aside, this formulation is interesting in proposing that three elements are tied together in a functional whole:

(a) certain forms of economic organisation;
(b) the pursuit of personal interests;
(c) the discovery and exploitation of opportunities for socially desirable changes.

In other words, it is not sufficient that the form of economic organisation should encourage people to discover new social ways of doing things while also serving their personal interests. The new ways must also be socially desirable. Nor is it sufficient that the form of economic organisation should merely encourage the emergence of people resourceful, imaginative and energetic in the pursuit of economic and personal interests. Those qualities of mind and character may be channelled, by one form of economic organisation, to the production of goods and the creation of wealth, and by another, to the destruction of wealth and barbarism, even though the latter may serve some personal interests.

By introducing the notion of the 'socially desirable' Kirzner both enriches and complicates the discussion. One effect is to force us to make explicit the nature of the ends or values implicit in conceptions of economic rationality. What is it that we want economic rationality, aided by a vigorous entrepreneurial spirit, to serve?

There can be no ultimate or unchallengeable answer to that question, and the only criticism we are entitled to offer to any answer is to point out its inconsistencies; a process which itself depends upon agreement that inconsistencies matter. But if, for argument's sake, it is agreed that the 'socially desirable' at least includes such things as liberty, abundance, justice, diversity, and individual enterprise, and provided we can give these terms some content, we will be interested as a first step in discovering what institutional forms and relationships tend to promote or hinder the achievement of these ends. This, so far as the 'end' of abundance is concerned, constitutes the subject matter of economics, and progress has been made in establishing relationships of support and opposition between the creation of wealth and other institutional orders; for example, the role of sophisticated science and engineering in developing more efficient production processes; or the part played by free trade legislation and agreements in promoting wealth and efficient use of resources.

So if, in this vein, a vigorous entrepreneurial spirit is seen to be one of the foundations of free market capitalism, our task is to enquire into the kinds of social and structural arrangements that work for or against the emergence and sustenance of that spirit. If we find that certain socio-economic institutions and practices serve entrepreneurship and that both these and entrepreneurship are conducive to liberty, abundance, justice, etc., then the criteria suggested by Kirzner will have been met.

II. THE ENTREPRENEUR IN THE SOCIO-ECONOMIC STRUCTURE

Let us define an entrepreneur for our purposes as 'one who sees an opportunity for producing wealth and organises its exploitation in socially desirable ways'.

We will not have entrepreneurs if our society fails to produce individual personalities with the desire and capacity to act entrepreneurially. Nor will we have entrepreneurial activity unless our society encourages it or at least tolerates it.

If genetic traits are relevant, it may be assumed they are randomly distributed throughout mankind. The crucial issues are therefore cultural. The vicissitudes of entrepreneurship in England, Singapore, Taiwan and Korea, correlated with important cultural changes, support this.

In what follows, I want to draw attention to those aspects of the socio-economic framework of our own and similar societies which are relevant for entrepreneurship and wealth-producing initiatives.

Entrepreneurial insight and effort, it is suggested, will not be forthcoming, or will be limited or debilitated if:

(a) they are not rewarded sufficiently to elicit motivation;
(b) they are technically legal but socially devalued;
(c) essential skills are lacking;
(d) access to industries and resources is difficult or prohibitive in cost, or if resources may be expropriated;
(e) there are countervailing inducements to direct effort away from the production of wealth in socially desirable ways;
(f) they are undermined and hampered by laws and regulations or by the absence of facilitating laws and regulations;

(g) there are radical uncertainties about the outcome of effort;
(h) the organisational milieu is sub-optimal.

III. REWARDS AND MOTIVATION

Like the rest of us, the entrepreneur needs to be motivated by the prospect of some significant gratifications - fame, status, riches, achievement, service to others, etc. - directly related to entrepreneurial effort. Conversely, failure should entail some significant personal loss otherwise resources will be wasted and entrepreneurs will never learn.

In a capitalist society these gratifications, for the entrepreneur, are tied to profits arising from seeing and exploiting an opportunity. It follows that the entrepreneur must have some property rights in the profits and direct responsibility in the disposal of the surplus of the enterprise or a significant part of the surplus. There is then a strong link between seeing opportunities and subsequent gratifications. This is what Kirzner means by people noticing 'that which it is in their interest to notice'.[4] In a socialist society this link is missing or greatly weakened, since no connection is systematically established between noticing an opportunity, being free to exploit it, and benefiting personally in a significant way. Although one can think of personal benefits other than sharing in profits (promotions, higher salaries, public honours, perquisites, etc.) it would nevertheless be necessary for a **consistent** relationship to be established and maintained, since it is this functional correlation which gives profits and any other differential rewards their motivational force.

As Hayek has argued,[5] a competitive price system is, amongst other things, a 'discovery procedure' which, through price signals, may point the way to entrepreneurial opportunities and the servicing of consumer wants. Socialist societies lacking a competitive price system are therefore severely disabled in finding opportunities for socially desirable innovations, no matter how entrepreneurs are rewarded.

In discussions of entrepreneurial motivation, David McClelland's *The Achieving Society*[6] is often mentioned. His thesis is that child-rearing practices may tend to encourage or inhibit the expression in socially useful ways of an innate need for achievement. These child-rearing practices in turn reflect broader cultural themes in the society in question which are lodged in literature, myth, definitions of heroism, and so on. As an explanatory device for seemingly sudden efflorescences of entrepreneurial vigour in historical epochs this view has not found much empirical support. In any case, reaching any goal at all (which humans are doing all the time) is 'achievement' in some sense, so the theory depends on distinguishing certain kinds of goals and achievements as especially significant; which brings us back to the importance of the **cultural** definition of what constitutes 'achievement' and the socio-cultural rewards attached to it. It is simply a re-phrasing of the problem we are dealing with; how do societies promote or thwart entrepreneurship?

It does, however, remind us that, granted the central role of 'rewards' or 'gratifications' in motivation, they are not altogether things we define for ourselves. In a very important sense they are defined for us by our societies and the ways of life we participate in, so that risk-taking behaviour, especially associated with entrepreneurship, would seem to have an important cultural dimension, being praised in one society or era and denigrated in another. But this brings us to a consideration of the role of culture in devaluing the entrepreneurial spirit and the consequences of this devaluation for individual motivation and the creation of a social climate inimical to entrepreneurship in general.

The devaluation of entrepreneurship

Those activities which societies or ways of life define as honourable or dishonourable become spurs or constraints for behaviour. The definitions of honour which issue from socialising institutions such as schools, churches, literature, the family, the media and universities play a major role in determining attitudes towards all activities and occupations, including entrepreneurship. Consider the following:

> . . . it gradually came about that the present age handed over the workers, each alone and defenceless, to the inhumanity of employers and the unbridled greed of competitors . . . [T]he whole process of production as well as trade in every kind of goods has been brought almost entirely under the power of a few, so that a very few and exceedingly rich men have laid a yoke almost of slavery on the unnumbered masses of non-owning workers.

These are the words, not of a left-wing pamphlet, but of Pope Leo XIII. They are quoted in an article in a leading national weekly.[7] First uttered in the 1890s, sentiments like these are now commonplace in Christian churches. But not only the churches. It would be tedious indeed to quote the evidence, but it seems quite accurate to say that free market capitalism has been struggling to defend its honour against overwhelming odds for the last 35 years and has largely failed, although the prospects have recently changed somewhat. It is an age of radical and undiscriminating egalitarianism where competition is defined as an evil whose results must be compensated by elaborate systems of re-distribution, protection and controls, increasingly entrenched within a vote-motivated political framework, its attendant bureaucracy and hordes of special-interest beneficiaries. Such an age is hostile indeed to a spirit which cannot exist without competition, freedom, uncertainty, risk, ambition, discovery and production. The entrepreneurial spirit is essentially opposed to an ethic characterised by risk-avoidance, security-seeking, protection, dependence and consumption.

The sources of the ideological denunciation of capitalism from Rousseau through Marx and the Fabians to Marcuse and Galbraith are well known. But the more limited question of the public status of the entrepreneur as its individual linch-pin has been the subject of limited research.[8] Insofar as the literature of a culture gives clues about what it sees as honourable and dishonourable, the image of the entrepreneur that emerges from English literature is, to say the least, ambiguous. The anti-industrialist humanitarianism of influential 19th century writers like Dickens has, on the whole, linked the costs of industrialism and not its benefits with the entrepreneur. Despite the fact that most Australians seem to prefer free enterprise,[9] it seems fair to say that this preference does not indicate an understanding of the crucial role of the entrepreneur in maintaining it. If this is true, the English literary traditions of this country have no doubt played their part.

Within the mainstream of contemporary culture, one's impression is that in intellectual circles, in the media and amongst the 'new class' of 'scientists, teachers, and educational administrators, journalists and others in the communication industries, psychologists, social workers, those lawyers and doctors who make their careers in the expanding public sector, city planners, the staffs of the larger foundations, the upper levels of the bureaucracy, and so on', (as Irving Kristol[10] characterises them), an anti-capitalist, anti-entrepreneurial bias is uppermost. Insofar as one may take these groups to be opinion-leaders and formers their thrust is towards devaluing and dishonouring the role of entrepreneur whilst honouring the apparatus and occupations associated with regulation and 'welfare'.

IV. THE SKILLS OF THE ENTREPRENEUR

Much of what has been said so far puts the emphasis on social climate, tradition and structural arrangements as important for the emergence of an entrepreneurial spirit and motivation. Nevertheless it is a spirit which does not work in a vacuum. In a complex, developed society both the seeing of opportunities and their exploitation require some knowledge of how the system - or a particular part of it - works. Clearly, such knowledge does not necessarily have to be of a highly technical or sophisticated kind, but no matter how simple the nature of the enterprise itself or however obvious the 'opportunity', successful exploitation demands that various marketing variables - suppliers, consumers, competitors, sales - must be assessed, resources must be acquired, deployed and organised, people managed and so on. For most entrepreneurs such skills and knowledge are gained the hard way - on the job as an employee or later on in the successes and failures of the market place itself. In some circumstances these skills might be more important than basic literacy or numeracy, but this is unusual. In the ordinary course of events more sophisticated skills make the entrepreneurial row much easier to hoe, and beyond secondary education, tertiary training in such areas as management, marketing, economics, accounting, organisation theory and finance has a part to play, not so much, perhaps, in generating entrepreneurial motivation as in giving it some of the equipment for successful exploitation.

It is an interesting question whether such broad managerial training makes any contribution at all to entrepreneurship within the community or to entrepreneurial management. Some management teaching tends to encourage a rather sterile, technocratic bureaucratism, emphasising rational, linear thinking rather than the discovery of possible ways of connecting the previously unconnected so that something novel might come into existence. There is, in such entrepreneurial insight, an affinity with the process of scientific or artistic discovery; but just as we can devise no programs that will guarantee great art or great science so we cannot teach entrepreneurial insight. As with scientific and artistic creativity, the best we can do is teach principles and techniques and try to provide a cultural milieu which offers the materials to work with in a propitious social ambience. The fruitful marriage of sophisticated skills and appropriate climate is reflected in the fact that many of the entrepreneurs in the new, emerging industries such as microelectronics and biotechnology have been engineers and scientists.

V. ACCESS TO RESOURCES AND INDUSTRIES AND EXPROPRIATION OF RESOURCES

There can be no exploitation of wealth-producing opportunities without the resources to do so. The entrepreneur must accordingly have capital and be free to recruit labour. Anything which reduces the available capital or interferes with the recruitment and deployment of labour hampers entrepreneurship.

In a more or less liberal capitalist economy all citizens are formally free to become entrepreneurs in lawful profit-making pursuits, subject to some qualifications mentioned later. In a socialist society, the number of potential entrepreneurs is formally limited to defined classes of citizens with decision-making powers in relation to capital in public bodies. The ordinary citizen, unlike his capitalist counterpart, is forbidden, apart from a few minor exceptions, from using capital (even his own savings) and engaging free labour for enterprises which are not otherwise illegal.

This built-in limitation on the class of entrepreneurs, rather than the absence of capital per se, is one feature of entrepreneurship in socialist countries which, together with the loss of the 'discovery procedures' of changing prices, works against entrepreneurial innovation. In such countries this is compounded by the premium placed on working to a plan, which implicitly defines out the kind of experimentation and risk-taking which might lead to useful discoveries or, even in the failure of risky ventures, to the acquisition of useful knowledge - itself a kind of capital.

This capitalist freedom, then, enlarges the proportion of the population which might become entrepreneurial. But its practical consequences depend on the amount of capital actually available for entrepreneurial use. Anything which diverts capital elsewhere or significantly delays its availability reduces private entrepreneurial possibilities. Taxation is, of course, the most important means by which this diversion is achieved. Shortage of risk capital and the high cost of loan funds when interest rates are high because of large-scale government borrowing must accordingly reduce the opportunities for private entrepreneurial action. Perhaps this would not matter so much if we could be sure that the capital diverted to the public sector was devoted to the creation of wealth and not frittered away in administrative-distributive costs and the buying of votes.

But it is not only by diversion of capital that governments make access to resources and industries difficult for the entrepreneur. In this country we have numerous examples of Federal and State governments regulating industries through tariffs, licences, subsidies, price-fixing, restrictions on competition, 'agreements', 'rationalisation' and 'orderly marketing' arrangements, legalisation of professional monopolies, and so on, the total effect of which is to severely restrict entry and competition.

With the outstanding exception of the New South Wales Government's recent revocation of freehold rights to coal lands in the State, government expropriation of the capital assets of particular enterprises without adequate compensation is rare in this country. However, Ivor Pearce makes the point[11] that in England - and the situation is much the same in this country - trade union power and legal immunities enable unions, under threat of completely closing down an organisation, to raid the capital in order to get wage increases. Accordingly, it is in the interests of the organisation to pay up rather than close down. The result is declining capital, stock and productivity and the exacerbation of inflation.

Under such circumstances the inducements and resources for entrepreneurial initiatives are severely circumscribed.

VI. COUNTERVAILING INDUCEMENTS TO MISDIRECT EFFORT

Anything which forces or induces the entrepreneur to orient his efforts away from directly wealth-producing activities and increasingly towards instrumental and non-productive work can be regarded as a waste of resources. In relation to government intervention, it is worth mentioning that insofar as this intervention takes discriminatory legal form by giving selected groups special privileges in the way of licences, exemptions, exclusive rights, and so on, it has a profoundly divisive effect within the business world. It breeds resentment, cynicism and hostility and a lot of destructively fruitless effort. Moreover, businessmen rapidly become incorporated into the system; they routinise and embed practices such as lobbying, monitoring government activities and public relations which erode wealth and productivity and introduce a lot of 'noise' into the information-exchange functions of the market.

Inflationary environments also tend to make mere trade, without production, profitable and thus to misdirect entrepreneurial effort to that end. The faster inflation grows the more profitable it becomes simply to hold stocks without adding to their quantity.

VII. THE ROLE OF LAW

The use of law and regulation as interventionist tools by governments has been well discussed and the inhibitory burden it places on enterprise is well known. The regulatory balance sheet, for good or ill, is too large a topic to be canvassed here. It is sufficient for our purpose simply to record the point that legislation and its consequences for economic rationality and entrepreneurship are absolutely vital in any consideration of the compatibility between economic institutions (including entrepreneurship) and non-economic institutions.

The *locus classicus* for these issues is F.A. Hayek's three-volume *Law, Legislation and Liberty* with its emphasis on the ordering (and liberating) power of general rules of universal application, and the contrast between the employment of such principles and the incoherent, unpredictable, illiberal and arbitrary character of social life when they are abandoned and when law is seen simply as that which governments ordain, usually in the piece-meal servicing of particular interests. It is the foundation of 'the war of all against all'. One major example of this state of affairs is the current chaos of Australian industrial relations and wage-fixing arrangements. These constantly present object lessons in the partiality of industrial law and the effective suspension of the common law for privileged groups, with the spoils going to the ruthless. The consequences for rational entrepreneurship and the production of wealth are only too well-known.

VIII. RADICAL UNCERTAINTY

There is always an element of futurity involved in 'seeing' an entrepreneurial opportunity. The entrepreneur's assessment of whether a present situation constitutes an 'opportunity' for wealth-creation depends upon his confidence that certain crucial features (e.g. property rights) of the present situation will continue into the future. Although some risk and uncertainty can be discounted, beyond a certain point radical uncertainty will raise the level of risk beyond what is acceptable. If the degree of uncertainty is roughly proportional to futurity, projects with longer lead times will tend to be abandoned in favour of shorter term ones, with major implications for future wealth.

Arbitrary government, 'changing the rules of the game' for short-term political gain, such as the petrol-pricing policies of the New South Wales and South Australian governments, and the abrogation of mining leases by State and Federal governments, are current examples of this kind of uncertainty.

IX. THE ORGANISATIONAL MILIEU

How do corporate structures affect the entrepreneurial spirit? Is size of the corporation an important variable? Is entrepreneurship more likely to be found at the top, or in the upper-middle ranks? Is it more likely to appear in some functional areas than others - say, in marketing rather than production or finance? Is it more frequent in divisionalised or functional structures?

The short answer is that, so far as I am aware, there is no conclusive evidence one way or the other. One would expect, however, that four things are required to elicit and sustain individual entrepreneurship within the firm:

(a) structural arrangements which allow the possibility that the discoverer of an opportunity can participate in its exploitation;
(b) close connection between discovery, exploitation and 'rewards' (not necessarily profits);
(c) an organisational 'climate' which encourages innovation and risk-taking;
(d) sufficient organisational 'slack' (i.e. surplus resources) to accommodate interruption and rearrangements of ongoing activities and organisational capacity effectively to deploy that slack.

We are assuming, of course, that it is employees who have an entrepreneurial insight, but unless that employee has the authority to commit the firm's capital resources to a new venture, it could be argued that the real entrepreneur is the person who does have this power and responsibility and acts on it, even though he may not have had the original insight.

Be that as it may, there seem to be interrelationships between size and structure and the four factors mentioned above. It can be argued that size and economies of scale depend heavily upon routinisation, typically found in large-scale production organisations. Rigid rules and established patterns, the 'machine bureaucracy' which depends heavily on standardisation for coordination, is typical of this kind of organisation. Since innovation requires the breaking of standard patterns, we would expect that organisational inertia, not to speak of size of investment in existing arrangements, would work against entrepreneurial initiatives in such situations. Henry Mintzberg[12] has explored some of those structural features which work for and against innovation and has related them to a number of factors - especially uncertainty and rapidity of change - in the external environment.

George Gilder[13], quoting Burton Klein's *Dynamic Economics*, refers to the frequency with which new developments emerge not from the leading companies in an industry but from relatively small ones:

> Even when a breakthrough is made at a large corporation (such as the transistor or photovoltaic solar cells invented at Bell Labs), the new item is usually launched commercially by smaller businesses, often started by breakaway teams of engineers and managers from the parent firm . . . Klein shows that this pattern of leadership lag applied, in varying degrees, to all fifty of the key twentieth-century breakthroughs he studied. The very process of rationalization and bureaucracy by which a company becomes the most productive in an industry tends to render it less flexible and inventive. An exclusive preoccupation with statistical productivity - simple coefficients between inputs and outputs - can lead to a rigid, and in the long run, unproductive economy.

On balance, then, it seems likely that large size, especially if allied to large-scale production in a centralised, functional structure is less conducive to entrepreneurial innovation. Divisional structures, which are more akin to federations of semi-autonomous firms, have advantages in terms of smaller, more flexible structures and, if they are profit centres, the stimulus of internal competition, a sharper appreciation of relevant external competitors and greater sensitivity to consumer wants.

X. CONCLUSION

This discussion of some of the socio-cultural variables which influence entrepreneurship is necessarily incomplete. But I hope sufficient has been said to make the point that the entrepreneurial spirit, if it arises at all, is the outcome of a highly interactive process which depends upon favourable conditions within major institutions. 'Favourable conditions' comes to mean, primarily, free access to resources and predictable property rights within a framework of non-obstructive and non-discriminatory law. It also means, ideally, a social climate in which risk-taking in productive enterprises is seen as honourable and its rewards as legitimate. It means an economic climate free of the seductions of profit without production, and organisational forms which are flexible and responsive.

These are abstract requirements. The reasons for their presence or absence in a particular society, or their particular form, can only be found by historical investigation of concrete situations. Such an investigation would lead us much further afield than we can go here. It raises questions of ideology and traditions and the evolution of political and other institutions and the clashes within and between them. It lead us, in short, to those diverse social movements which are the creators of institutions, which endow them with life and plurality of purpose and which sometimes come to change or destroy them. What can be said, though, is that in the last resort **how** certain sorts of institutional arrangements work themselves out dynamically is an empirical question. The unravelling of these interconnections has been one of the great contributions of recent economics and political economy, especially the 'economics of politics'.

To come back to the issues we raised at the beginning, if we seek to arouse and direct the entrepreneurial spirit to certain 'socially desirable' ends, we must know what we want and we need to discover the means of linking human energy to those ends through certain shaping and facilitating institutions. The study of free market economics has shown us how one set of institutions that was not, and could not have been, pre-planned works towards producing abundance and, in doing so, cooperates with, and is in turn dependent upon, free entrepreneurship. Insofar as political institutions and their ways of working are found to hinder free markets, we would accordingly consider this undesirable, unless we also found that those ways of working were highly conducive to liberty; in which case we would have a problem. But whether the political system **does** so work is one of those central empirical issues, and what we might do about it then provides the stuff of political dispute and organisation.

To put the issues in this way is to emphasise, then, that any way of life is many-faceted, that it has a plurality of ends and activities deemed by some to be valuable and that they mutually influence one another. None of them can prove its priority or that its rationality is the foundation of all other rationalities - as Marx tried to do for economic production. Within any society there are many different ends that can be pursued rationally; that is, by efficiently and consistently matching means to objectives.

The best we can hope for, and seek, is wider and wider 'adjustments' between ends and means. Investigating the role of the entrepreneur in the good society is what this forum is largely about.

> The choice of which end to pursue and what goals to be rational about is not itself deduced and is never irrefutable or final. Any such choice will remain open to competition and criticism from other sorts of rationality. None of these competing or successive applications of reasonableness and discipline can produce an absolute warrant, and none could establish a claim to be the only rational way to live. This circumstance that ways of life are neither deduced nor proven opens no gate to irrationality, however, for in order to be ways of life or social movements they must consist in the creation of institutions, laws, moralities, and coherent world-views. That is, they must be reasonable.[14]

The entrepreneurial spirit is fundamental to economic enterprise and discovery. It is the innovating, creative core of capitalism. It, too, depends for sustenance on finding a place in a 'coherent and reasonable world view'. Its creativity requires freedom. When it is free it opens up creative possibilities in all areas of social life. It is 'enterprising' in this special sense. The crucial point, therefore, is not merely that the crippling of the entrepreneurial spirit in the market place is economically calamitous (though of course it is) but also that it diminishes liberty in general and leads steadily to political servility and the virtual extinction of enterprise in **all** fields, except perhaps the entrepreneurial arts of the courtier and the gaoler.

Notes

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The Entrepreneur, The Economist and Public Policy

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The Entrepreneur, The Economist and Public Policy

Malcolm Fisher

I. ENTREPRENEURSHIP IN ECONOMIC THEORY

Economists customarily assign the entrepreneur only the most meagre role in the economic system. This is perhaps more apparent today than in earlier times but it has always been true. Modern theories of competition leave him out of account entirely.[1] In theories of the business cycle if he is admitted at all it is in the role of an external unexplained element to which an economy has to react.[2] Modern theories of portfolio selection have been usefully extended so as to bring the probabilistic calculus to bear on managerial decision-making as well as the disposition of assets in a manner such that the entrepreneurial function is virtually foreclosed.[3] It is indeed ironic that the twentieth century, the period which has witnessed spectacular real growth, should have been the one when the entrepreneurial role was especially downgraded. Schumpeter in his doctoral thesis[4] prominently highlighted the entrepreneur's role and potential power but his insights - so often remarked upon in analytic meetings - have been largely smothered in the development of the subject in practice.

Even Schumpeter gave some encouragement to this for he prophesied a decline in the entrepreneurial function, in this leaning towards the historical predictions of Marx, himself no supporter of the entrepreneurial role. Today, the prognostications of both these scholars look thin. Of course Schumpeter always stressed the transitory role of any single entrepreneur - a person who is an entrepreneur at one time may not be at another - so that we are not entitled to link any identifiable person with entrepreneurship save over fleeting intervals of time.[5] Entrepreneurship, which he defines as a carrying out of new combinations - markets, products, factors, techniques, organisational arrangements - accords the initiator short-term returns of a monopoly character but these are essentially transitional, competition working to annihilate any excess return as others emulate. However, the economy ends up richer in the quantum of goods and services as a result of the originating activity.

Transitory profits to the entrepreneur go hand in hand with **permanent** real returns to the economy at large.

The fact that the entrepreneur introduces something different and unexpected places a strain on the notion that all relevant considerations can be contained within a decision process based on alternatives with precisely known probabilities attached. This point is closely related to Frank Knight's[6] insistence that risk (known problems) must be distinguished from uncertainty and John Hicks'[7] demonstration that modern portfolio selection and liquidity preference models manage to lose 'liquidity' altogether in the process. Liquidity is desirable because one does not know what will happen next; one feels that events may differ in some unclassified way from what one has taken into the assessment through opening up or foreclosing options. A reserve for coping with this style of unexpectedness should be kept - 'liquidity gives one time to think'. Modern theories cannot explain the phenomenon of 'going short', in this sense, in financial markets. In the context of labour markets, economic analysis offers no explanation as to why workers should remain fairly flexible in the variety of skills they can perform.[8]

Again, Keynes[9] in his chapter on longer-term expectations in the *General Theory* speaks of the role of 'animal spirits' and the uncertainty surrounding the marginal profits on capital. In this sense he appreciates some of the special qualities of the entrepreneurial function - as Kirzner would say, the lack of self-awareness and the significance of 'hunch'.[10] Modern theorists have virtually eliminated this aspect in their search for tidy-minded models.

Mathematical model builders, whether constructors of general equilibrium or macroeconomic structures, do not like untidiness and loose ends and any residual elements get speedily swept up in stochastic residual terms, or ignored. Narrow markets, and stochastic elements that cannot be contained within readily manipulatable probabilistic systems are otiose.

New ideas, new techniques, new markets are swept aside in favour of consistent sets of markets that should be maintained over finite time, state and space to form complete markets. Their absence in the workaday world is used as evidence against the presumed advantages of competitive systems. The alternative structural systems to which we should be attracted are not usually specified, but they inevitably give high priority to central planning. The facts speak differently - people hold money because today's expectations are conditional on alternative events of the morrow and people want to 'wait and see'. Some buy new goods as soon as they enter the market, some want to wait until they have been tested and tried. These appear small elements yet when they lead to market gaps because possible purchasers or sellers do not elect to participate at all, microtheory does not currently cope with them. The larger manifestations of new products and techniques that have led to new industries and displacements of others as well as to a rearrangement of the whole infrastructure are noted, but not specifically allowed for. In our small trading country, local theorists may feel they can ignore these aspects, for Australia may import a number of these products ready-made from foreigners and the timescale of absorption may be such as to bring them within an extension of the routinised circular flow of Schumpeter. Yet by no means all can be accounted for in this way. We export techniques and marketable ideas; we develop some purely for indigenous use.

Even Schumpeter's notion of transitional monopoly power that accompanies, say, lower cost production and produces lower real product prices, has never been accorded more than a footnote in the monopolistic competition literature; in this writer's long-held opinion[11] Schumpeter has come closer to the bull's-eye than those presenting alternative arguments.

Of course, the innovations that entrepreneurs bring do not need to be large, nor inventive as such. Often things that we all see around us are merely grouped differently, and the result 'gels'. An entrepreneur can be just an ordinary guy - he does not even have to have property. And what he produces successfully today, while according him transitory monopoly-type returns, may never be followed by another entrepreneurial contribution from the same source.

With the description of the entrepreneur and his actions so obscure and indeed only temporarily associated with one individual, it is small wonder that public policy cannot be directed immediately to service his needs.

Yet anonymity is an important advantage of the competitive process and the fact that the contributor of entrepreneurship today may not contribute tomorrow, fits neatly with this situation. Public policy can not, and, as we here argue, should not, be directed towards specific individuals.

Von Mises went further[12] and argued that anyone can be an entrepreneur, and that people who are entrepreneurs at one time need not be at another. Is there any need then for public policy concern or intrusion?

II. PUBLIC POLICY AND ENTREPRENEURSHIP

At a minimum public policy is concerned with defence of the realm, civil order and the development of law and due process. Governments also have the power to tax and at least indirectly control the currency of the realm. A 'public goods' case can be readily made for each of these as Adam Smith, the architect of 'laissez-faire', would have maintained had he possessed the terminology.[13] Governments tend to go much further engaging in buying and selling, in lending and borrowing, in taxing and spending, in regulating and licensing, in pricing and allocating. Social cost corrections and monopoly apart, competition in the contemporary model is assumed to offer optimally efficient conditions but not to prescribe the distribution of income and wealth that is best. Some trade is better than no trade but free trade is not necessarily better than some trade. Lump-sum taxes and subsidies (do they exist?), it is argued, will adjust the efficient economy to preferred income and wealth distributions.[14] On the other hand, for economists who assign entrepreneurs active roles in helping determine the pattern of new goods and new techniques, such 'accepted' competitive models need modification for it is maintained that competition is itself a process of discovery,[15] not something preordained.

This modification of accepted theory cannot be bought without cost and we are now denied the right to take over competitive Pareto-type propositions and assume lump-sum tax and subsidy corrections can be deployed to settle on that one of the efficient allocation systems which has the most desirable income and wealth distribution across the community. The notion that if one organises disposition of resources in the economy efficiently, distribution issues can be taken care of by suitable policies exercised through the taxation system, is no longer obviously consistent with this view. We are then forced to stand on the weaker proposition that reductions in the impediments to trade will gradually loosen up the economic system so that patterns of distribution become less congealed. One may see 'clogs to clogs' in two generations instead of in three. Privilege maintained over time becomes less a matter of concern. In saying this we in no way imply a harsher stand against the provision of a safety net for genuine cases of need than apply in the alternative model.

The entrepreneurial competition theory establishes the case for a reduction in controls and regulations of all types, of redistributive taxing and spending, and so on. Social corrections and anti-monopoly corrections then need to be argued as special cases and preferably met in a democratic system through specific provisions that are voted on at moment of granting and whose retention over time has to be justified. To illustrate, this means that in an international trading context, subsidies will be preferred to tariffs.

The speed at which these measures of decontrol are introduced is basically a non-economic question which politicians cannot duck. Their response will be influenced by the balance of political advantage and this in part depends upon the degree of social tension that will arise if action is speeded up or unduly deferred. It is of interest to remark that the Campbell report on the financial system[16] draws upon the accepted theory of competition rather too strongly, considering its uncertain empirical relevance. The report discusses its recommendations in the light of associated improvements in efficiency, but chooses not to confront the question of distribution arising from its recommendations for reform. Yet these recommendations for freeing up the financial system depend on the securing of efficiency in other sectors of the economy - questions not even addressed given the specific terms of reference. As such the recommendations are not obviously consistent with the Pareto-type competitive model upon which they draw but would make much more sense in the context of the Austrian theory. In this theory distribution effects can become dispersed over time in the context of a gradual phasing-in of efficiency improvements.

III. ENTREPRENEURSHIP, ECONOMICS AND PUBLIC POLICY

At present in Australia the political response is in the opposite direction. Regulations in restraint of trade multiply - consumer standards regulations, professional body regulations (plumbers, electricians, etc., now joining the doctors, lawyers and accountants), tariffs and quotas to the long protected industries (motor vehicles) and so on. These moves have the effect of inducing creative endeavour to become concentrated upon negotiations with Canberra or the State capitals, a response that whilst productive to some individuals is less productive to the community as a whole. Freedom of entry is being whittled away in favour of the privilege of a few. A.C. Pigou writing in 1903[17] put the basic point concisely:

> Under it [protection] there is - to put it at the lowest - a not inconsiderable chance that manufacturers, confronted with competition, will expend energies, which might be best devoted to discovering more economical methods of work, in the sordid trade of 'persuading' and 'influencing' legislators. From this it is not impossible that log-rolling may develop, different industries making treaties of mutual support in the scramble for tariff doles . . . While the theory is that protection is needed for the weak, in practice it is those who can shout loudest, lobby best, and pull wires most effectively to whom the boon is prolonged.

Or to quote Henry Sidgwick in 1883[18]:

> It is easy to show that protection, under certain not improbable circumstances, would yield a direct economic gain to the protecting country; but from the difficulty in securing in any actual Government sufficient wisdom, strength, and singleness of aim to introduce Protection only so far as it is advantageous to the community, and withdraw it inexorably so soon as the public interests require its withdrawal, it is practically best for a statesman to adhere to the broad and simple rule of taxation for revenue only - at any rate in a free community where habits of commercial enterprise are fully developed.

It may seem a mistake to link economic theory with public policy but there is much substance in Keynes' remark,[19] 'Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist'.

Perhaps this is nowhere illustrated more vividly than in the public policy implications and policy measures derived by the Keynesian School, though not without considerable qualification by Keynes himself, from the *General Theory*. Full employment schemes premised upon increased fiscal spending and sustained expansions in the money supply have turned into inflationary wages and prices accompanied by only transitional expansions in employment. We are back to the Keynes concerns of 1919 in his *Economic Consequences of the Peace* where he *inter alia* quotes Lenin to the effect that the best way to destroy the capitalist system is to debauch the currency.[20]

As we are finding, inflation feeds on itself, creates haphazard redistributions of claims on resources, builds enmity and fear, undermines the natural system of contracting and especially curtails commitment to longer-term investment projects. It also erodes confidence in money, the central element underpinning our present day structure of specialised production and trade. Inflation can be cured by drastic measures, though it is difficult for politicians in democracies to generate the conditions for accomplishing this speedily while ensuring political survival. Entrepreneurs can find arbitrage opportunities aplenty in an inflationary world but such opportunities arise more in the context of deals involving existing property than in the creation of new goods, especially those involving long-term investments. Some of the supply-side economic writers, such as George Gilder, have made much of this point.[11] To misconstrue Keynes[12] who expressed concern at the building of pyramids (though he thought this would give people jobs) it is now rather clear that such activity cements the inflationary process in much the same way as the hoarding of goods.

The containment and running down of inflation could be adjudged one of the most advantageous measures for governments to adopt at this time though the political costs might be high, and the process itself would be handicapped by the international transmission of inflation.

Kirzner[13] emphasises that entrepreneurship is costless so that incentives are not required for its exercise. But, to a marked degree, public policy can influence the domain over which the entrepreneurial function is exercised. Present day inflationary trends are inimical to real growth and we therefore would argue that their arrest is likely to redirect entrepreneurial effort into more productive channels. Signals about fruitful areas of enterprise, normally conveyed through prices, are distorted by inflation and efforts to reduce the noise in such signalling are worth making.

Fear of the effects of inflation leads to further perverse behaviour by governments which are inclined to increase protective barriers to trade when stagflation occurs and to enhance legislative protections for their own employees, already largely job secure, by building in inflation-proof pensions. These are guarantees that the private sector cannot give as it is subject to an ultimate sanction, bankruptcy, for over-commitment.

The regulatory enthusiasm of government is much intensified in inflationary times and hence the distortions multiply. With lower inflation and more real investment confidence the effects of an even a small innovation may bring a considerable spread of associated activity in closely related industries. Given the choice between these alternative policy directions it seems comparatively easy to decide which is preferable.

Again, it is the economic writings of the 1920s and 1930s on monopolistic competition that have significantly determined the anti-monopolist policies adopted in legislation and regulatory practice. Yet often the wrong target is identified. Small numbers of sellers in a domestic market may be balanced by many sellers in closely related goods in international markets, though this argument does not extend to purely domestically-produced goods. Without clear criteria to determine the initiators of productive change, entrepreneurial effort may be snuffed out or misdirected. However, many of the glaring cases are in the factor markets the result of regulations of standards of performance and entry in occupational skills. Attempts at consumer protection have on many occasions led to the state only generating consumer frustration as it enhances the role of the firms currently in possession, yet escaping blame for its misdeeds. Freedom of entry and the denial of patronage and special protection will enable the entrepreneurial function to be directed into more socially profitable channels. In other cases state action may have led to too many market participants rather than too few. This may be true of the Australian labour market where the arbitration system has probably encouraged the persistence of an exceedingly large number of small unions with their unending demarcation disputes.

State interferences in the manufacture and marketing of products and of factor services have become such an important contributor to the ossification of market structures that no effort should be spared to drive home the fact that these are inimical to progress. Fear and the power of patronage have much to do with their persistence and growth but the weaknesses in the economists' own models have strongly reinforced what are here adjudged mistaken beliefs. In Australia today governments, rather than firms, have become the main initiators of processes in restraint of trade. Ironically this process has been led, to a considerable extent, by the implications drawn from theories of inter-firm competition.

Periodically failures in performance become sufficiently glaring that a community check is brought to bear but ultimately the question of where policy should be directed has to be sorted out at an intellectual level. The perfecting of entrepreneurial theories of competition offers one of the best means to that end. Just how difficult is the task is indicated by Schumpeter's failure to convince the profession even though he sharpened the contrast between the familiar and the routine in order to do so. But despite Kirzner's claim that in so doing he mistakenly stressed the import of large as opposed to small and well dispersed innovations, it would seem that his approach taken up afresh would provide the best method of questioning the deficiencies in currently accepted theory.[24] To do this it seems important to draw attention to currently observed behaviour patterns that do not square with that theory.

Another pertinent illustration of the entrepreneurial elements in society at large is provided by the underground economy. While law-breaking should not be condoned, stretching the interpretation of the law to the absolute limit may well be sensible, indeed entrepreneurial. All of us can easily adduce examples of the cash economy which is rampant in the servicing trades, especially those associated with building. One can readily observe that even large companies resort to the cash economy in some of their transactions. The recent Reserve Bank annual report draws attention to the personal holdings of 50 dollar notes at an average of three per person. This seems to fit with an already observed substantial rise in currency holding relative to national income per head in certain European countries, such as Italy. The surface economy seems to be declining relative to the underground economy. Tax avoidance and evasion seem to be growing and governments are continually revising the legislation to plug loopholes.

The real problem lies elsewhere in the high marginal rates of tax and the impact of movement of people into these high tax ranges as inflation augments nominal incomes.

The appropriate governmental response is to lower marginal rates and to curb inflation. Egalitarian appeals of high marginal tax rates make little sense when those that governments want to charge respond by opting out of the tax system. Far better it would seem to switch to at least a linear income tax schedule where the marginal rates are constant. It can be easily shown that this would permit lower tax rates than at present and yet enable the government to secure larger revenues because the advantages of opting out of the tax base would be reduced. The fallacy in present tax arrangements is the assumption that the taxable base is stable. Entrepreneurial ingenuity has manifestly been directed to ensure that that is not so - much creative endeavour latent in the population has been exercised in shifting from a high-tax situation to a less onerous one. From society's point of view it could be argued that it would have been far wiser to direct those endeavours into more creative channels, such as more conventional organised market activities of production and accumulation. As long as activity through the more conventional markets is penalised, so long will the underground economy expand at the expense of the surface economy. George Gilder[25] identifies four leading groups of beneficiaries - legitimate, illegal, real estate, and non-profit concerns - what might be called the above ground, underground, ground and ungrounded economies. These he illustrates vividly but it is sufficient here to indicate the type of activity associated with the first and last categories, those not yet discussed. The first covers business lunches, conferences in pleasant places, free medical insurance and cars - the use of tax shelters and avoidance devices. The last covers non-profit organisations such as charities which stand to gain from the tax deductions offered for funds given to them, deductions that are more profitably sought when the opportunities for customary production and accumulation are penalised severely.

IV. CONCLUSION

Entrepreneurial elements are manifestly very active in Australia today. Do we want them creating for purely private advantage in an inflationary environment, or working to less social advantage in the underground economy, or do we want public policy to channel them simultaneously for private and social advantage of Australia as a whole?

Notes

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Entrepreneurship versus Static Enterprise

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Entrepreneurship versus Static Enterprise

Michael G. Porter

I. INTRODUCTION

Change lies at the heart of entrepreneurship. The entrepreneur perceives new profit-making possibilities and alternative ways of doing things - he has a vested interest in change. Since Adam Smith, economists have accepted that self-seeking entrepreneurship will generally be in the public interest, in that the provision of new products, new opportunities and so forth will only prove profitable if others choose to buy them. However if we place this same entrepreneur within a state enterprise devoid of conventional profit incentives, and characterised by a set of rigid rules, regulations and precedents, we typically remove the incentives to efficiency and socially desirable change; on the contrary, bureaucratic manipulation of public funds for the benefit of particular individuals and groups is now a predictable outcome. Indeed, the purpose of taking such activities away from private ownership is presumably to facilitate outcomes which would **not** pass market tests. Whereas the entrepreneurs in both private and state enterprise are induced to maximise their own salary and non-pecuniary benefits, subject to the externally set constraints, the constraints in the private sector typically reduce to a single word, profits.

In contrast to the situation in the private sector, there is little incentive in state enterprise to increase revenue or reduce costs, unless these should somehow directly allow increased benefits to the individuals or groups concerned. While the 'rules of the game' in state enterprise are typically intended to induce the public servant to act in the public interest, and while many, perhaps most, public servants strive to work in the 'public interest', monitoring costs and other barriers to information typically mean that the chosen path of the public servant is one which can ignore the interest of the public. It is usually too expensive to devise simple or meaningful measures of conformity with 'the public interest', whereas in the private sector, profits provide a measuring stick, often capitalised in sharemarket values, which induce alternative owners and managers to take over should the existing management no longer be seen to have a comparative advantage in directing the particular activity. No such discipline threatens the public servant.

If we restrict ourselves to commercial perceptions of the entrepreneur, we can do little better than contemplate the entrepreneur as described by Israel Kirzner:

> The pure entrepreneur, on the other hand, proceeds by his alertness to discover and exploit situations in which he is able to sell for high prices that which he can buy for low prices. Pure entrepreneurial profit is the difference between the two sets of prices. It is not yielded by exchanging something the entrepreneur values less for something he values more highly. It comes from discovering sellers and buyers of something for which the latter will pay more than the former demands. The discovery of a profit opportunity **means the discovery of something obtainable for nothing at all.** No investment at all is required; the free ten dollar bill is discovered to be already within one's grasp.[1]

The successful entrepreneur, then, is one who perceives the possibility of beneficial change and succeeds in arranging matters so that the change takes place. As the body of knowledge in our society alters, as history unfolds, and as the political and legal rules change, so we see individual entrepreneurship bringing forth a constantly changing menu of political, social and economic outcomes. In the case of political entrepreneurship there is no presumption of public good from all this change - on the contrary, the process is one predicted to benefit a section of the community which, in turn, will directly or indirectly assist the politician. To the extent we can avoid state enterprise we can also avoid the problem of funds being channelled from the public purse into the pockets of particular interest groups.

We can never precisely pin down the 'input' which accounts for many of these changes associated with entrepreneurship, since the entrepreneurial input is usually a non-quantifiable idea or vision. Unlike inputs such as capital, labour and natural resources, the input of entrepreneurship cannot be measured, or manufactured, in any obvious way - we simply detect that profitable change has taken place because some have seen possibilities not perceived by others.

There is often something of the successful scientist in the entrepreneur, in that the difference between the standard and the superior scientist is that the latter makes use of available information in such a way that scientific breakthroughs take place. Whatever explains the scientific breakthrough it is not just the available information, since that is often a public good. Just as any scientist can, in principle, put together the same body of knowledge on a particular topic, so too any businessman can, for a price, gather together the available information regarding market possibilities. Entrepreneurs, including successful scientists, are persons capable of making more out of that same body of knowledge.

II. IS THERE A NEED FOR PUBLIC MONOPOLY?

Legislators, perceiving the failure of markets adequately to assist particular groups, and having little confidence in the capacity of individuals to look after their own interests, are prone to create institutions such as public utilities with specified and relatively rigid objectives.[2] Systems of accountability are then devised in an attempt to achieve a more desirable set of outcomes by means such as cross-subsidies of freight rates, 'uniform' telephone charges and electricity tariffs, typically avoiding (more visible) taxes and subsidies. If the managers of state enterprises are political appointees, or at least subject to ministerial control, then it is a relatively easy matter for political interests to manipulate such bodies so as to benefit particular groups. To the extent these political objectives are taken as fundamental, this may make a case for denationalisation on the grounds that it is usually more difficult to induce private enterprises into cross-subsidising particular groups, since this would imply a reduction in the value of the firm to shareholders. While the scope for group cross-subsidies is thus a clear rationale for much state enterprise, economists have typically focussed on more mundane cost considerations, which, they argue, can make a case for public ownership for industries with sizable economies of scale.

It has traditionally been argued that the existence of sizable economies of scale makes it inevitable that there be a monopoly in certain key industries. The telephone networks, power generation, and other potentially large-scale enterprises can, it is argued, achieve least cost by using a single production unit. This argument is extended to suggest that the state either prevent the private sector from making monopoly profits by regulatory techniques (e.g. specifying a maximum rate of return) or that the state indeed **own** the enterprise and set prices so as to avoid charging more for a unit of output than the (marginal) cost of the resources used to produce it.

One difficulty associated with marginal cost pricing is that railways and telephone systems which do charge **marginal** cost (which has a short run efficiency justification) may not cover **total** costs in a situation of decreasing costs. In this situation the system will either be run down as the state authority proves incapable of maintaining it, or alternatively, special subsidies may be voted by the parliament to balance the books. In either case there are problems, because the former degrades the system whereas the latter degrades other parts of the economy, given that other sectors must now face taxation to allow the state enterprise to keep afloat. Moreover, once a public enterprise has drawn on the public purse, the incentive for it to minimise its costs is seriously diminished.

A preferred means of financing state enterprises is to devise rules such that revenue covers **total** costs with minimum distortion; but the public sector has proved notorious in neither finding nor implementing satisfactory rules of this kind. It is not our purpose here to argue the case for alternative pricing techniques for state enterprise subject to decreasing costs, but rather to note that inherent in the natural monopoly argument are pricing difficulties and a lack of incentive to minimise costs - problems which may in part be avoided by allowing private monopolies and choosing to run the risk of some degree of monopoly pricing.

Competition for natural monopolies

It needs to be noted, however, that in almost all fields claiming to be natural monopolies, e.g. communications, power transmission and railways, there is evidence of considerable scope for competition. Accordingly the conventional arguments regarding the need for state ownership may not apply. Indeed, in the United States the telecommunications industry is now finding that the existing telephone network is indeed not indispensable, and in any case competition can have a desirable impact on the previously monopolistic network. Cable, satellite, microwave techniques and associated computer-based technology offer alternatives to the traditional wired networks. In the case of power generation, there is an obvious basis for competition between private power stations and alternative sources of power.

A second weak link in the natural monopoly argument is that even if there is a case for monopoly based on declining costs, we would be better off risking private monopoly profits if the private ownership meant the possibility of private entrepreneurship - e.g. new services, new products, new markets - as opposed to the static situation we find in the communications, education and power industries, to which I now turn.

III. HOW TO DYNAMISE STATIC ENTERPRISE

It is perhaps no accident that those industries at the centre of criticism in Australian society today are those in which the state plays a major role. Let me single out just a few:

1. Energy - particularly power utilities
2. Communications - Telecom and Australia Post
3. Education - schools and tertiary education

The above sectors have problems which in many ways can be traced back to the lack of entrepreneurial activity and the dominance of the state in decision-making. It may be helpful then to review them one by one in an effort to discern possibilities for institutional change which may facilitate a larger role for entrepreneurship.

1. Energy

The last decade offers considerable evidence that price incentives and an absence of a threat of expropriation can create a veritable explosion of exploration activity. The price increases of 1973 and 1979 generated a shortage of oil rigs and the pegging of virtually every prospective lease in Australia, no matter how marginal. That price incentives create entrepreneurial activity in the field of energy exploration can hardly be questioned; on the other hand, when we look at the power generation industry we see just the reverse. Acts of Parliament in the various States lay down detailed (and often inconsistent) objectives for the power utilities. In some cases these objectives add up to sales maximisation and price minimisation, at the expense of a reasonable return to the social capital invested. In one case we have seen an almost manic desire to sell energy (i.e. gas in Victoria) regardless of the fact that the price is almost certainly some fraction of its value in alternative current or future uses. It is not surprising that much entrepreneurial talent appears to have left the state energy utilities, nor should we gasp at the blackouts and the associated horrendous stories of inadequate maintenance, antiquated pricing principles (which make no real reference to the opportunity costs of resources) and investment criteria which would be unacceptable in the private sector. In short we should have expected most entrepreneurs to avoid the power utilities over the last two decades - and to have left them in the hands of (often technically excellent) engineers. We now face considerable power difficulties partly because of the resulting dominance of non-economic decision criteria.

Politicians make promises regarding power supply on behalf of their power utilities, promises which they really cannot guarantee. On the other hand, businessmen rightly expect these promises to be met. It is not surprising, then, that the entrepreneur and the bureaucrat find it difficult to sleep in the same bed; yet as was the case in the much discussed resources 'boom', we see the expansion of the energy-intensive sector being frustrated by the incapacity of the energy producers to deliver the goods. We are not short of energy - we are not short of resources - we are short of entrepreneurship in the power industry. This means, incidentally, that we do not observe the pricing principles, which would enable us to economise on capital costs - say by pricing electricity by season and time of day - because (Victorian) State Electricity Commission officials are more interested in expanding the system than in economic returns.

2. Communications

It is now a commonplace to hear stories of a small jet touching down briefly on some remote airport in the Australian 'bush', throwing out a courier bag, and then taking off before a postie could blow his whistle or wipe his brow. Similarly, secretaries cannot afford the risk of using Australia Post for next day deliveries, since customers have become attuned to the private courier delivering on time. By way of contrast, in the city of Melbourne a letter may take three days to cross town, and a week to reach Sydney. These stark comparisons should surprise no one, since we have designed Telecom and Australia Post such that any real entrepreneur can only make money by leaving and starting in competition (if that is allowed).

The Acts creating Telecom and Australia Post, no doubt reflecting some belief in the 'natural monopoly' argument cited above, grant a monopoly of 'lightweight' mail to

Australia Post and grant Telecom quite remarkable monopoly powers in the area of communications. In contrast, in the United States we now see competition in communications, and while there are probably some natural monopoly elements in any network, it appears clear that if we deny competitive opportunities to the market in the field of communications we may miss dramatic new communications opportunities. The challenge, then, is to relax the rules and regulations governing the telecommunications network so that private enterprise can flourish. The 'chip', satellites and other new communications technology (including fibre optics and cable) offer possibilities for entrepreneurship which are so great that no Act of Parliament could ever contemplate appropriate rules. Accordingly, we have little alternative, I feel, but to preclude legislative, or 'static enterprise', approaches to the communications field. Rather, we must move towards some formula which respects entrepreneurship and which removes the state from its current domination of communications.

3. Education

Entrepreneurship in the schools[3]

At present parents are faced with the choice of a fixed amount of relatively uniform state education within which entrepreneurship and competition is all but prohibited, or a somewhat wider range of competitive private schools. In the state school system there is a severely limited capacity of parents to choose schools; indeed within some States it takes virtually a decision of the Minister to allow parents to send their children to a state school other than that assigned by the state. Parents, or potential entrepreneurs acting for parents, have virtually no say in the educational content of the school curricula. The hiring and firing of teachers is centralised and independent of the school council, which typically has only trivial powers; and there is quite limited capacity of the school system, through the parents, to supplement educational activities. Teachers are shunted around between schools as the result of decisions by bureaucrats in Departments of Education. As a result of all this there is little approximating entrepreneurial decision-making within the state school system. While there are pockets of excellence within various state systems - for example, in South Australia, where there have been many imaginative innovations - and while most States have some quite excellent state schools, by and large, parents are faced with either accepting a fairly rigid state school package or paying a substantial sum in the hope of obtaining an increment of higher quality schooling.

Parents choosing to reject the state school system obtain, effectively, a 'voucher' (labelled 'state aid' to private schools) which is but a fraction of the saving to the state involved in taking the student out of the public school and into the private school. Parents who choose to keep their children in the state system are not allowed to influence the allocation of taxpayers funds between state schools and teachers according to their preferences - as they would under a genuine voucher scheme.* They must either put up with 'their' state school or pay sizable fees for an alternative private school. As a result of this rigid structure, the marginal private cost of seeking to obtain an extra unit (in quality terms) of education far exceeds the marginal social cost. One frequent justification for these distortions is that competition within schooling would create an elitist situation in which families with superior incomes would supplement their child's education, thereby increasing the degree of inequality in the community. The irony is, however, that whereas a proper voucher scheme would allow great choice and variety **within and between** both state and private systems, the current system turns out to be more elitist than a 'pure' voucher scheme in which all citizens received an education voucher redeemable at any recognised school.

It should also be stressed that education is a clumsy and largely ineffective means of correcting income and other social inequities. Apart from the fact that a good deal of those attending non-government schools are from families of modest means, it is almost always inefficient to use education as the vehicle for redistribution. If the money currently spent on educational subsidies was removed, and used to subsidise those in genuine need or suffering, say through negative income tax arrangements, our community would, in my view, be a good deal more egalitarian than it is today. Additionally, given that many low income families choose to allocate a large chunk of their disposable income to their children's education rather than buy a bigger house, better car, or video tape recorder, they should not be penalised by the state for so doing. Yet families attaching priority to (private) education are penalised by the current system relative to those who opt for consumer luxuries.

A final point regarding the current regulatory structure for schools is that **it is entirely possible that the Australian**

community spends less on schooling than it wishes, precisely because of government subsidies to state schools. In essence, the argument is that a family may well choose to spend $1,500 per child per year on schooling in a totally deregulated system, whereas if the state school education is provided 'free', but financed by an average of $1,000 of taxation per student, then the family may quite rationally choose the lower quality and cheaper education, simply because it has a marginal cost of zero. Furthermore, they may not choose to supplement the schooling, given that the marginal cost of obtaining the extra private education may be of the order of $2,000. Accordingly, it is a matter of elementary economic theory that government subsidies to state school education may be producing a less educated Australia than otherwise.

Entrepreneurship in tertiary education

The educational process at the tertiary level might be described as supply-determined, with the academics and educational administrators providing courses of tertiary education which in many ways fail to reflect demand or cost considerations. While it is clear that the bulk of educationalists are sincerely concerned to provide education of the highest calibre, and while there are many examples of excellence within the tertiary education system, the rules of the game, as laid down in Canberra, have produced a system which is rigid and inflexible and often a major source of inequality in our community. The assertion that inequality is fostered by the current education system and its financial arrangements stems partly from the fact that on the 'demand side', the beneficiaries of 'free' tertiary education are typically from above average income groups, and, on the 'supply side', those retaining job security as academics in the tertiary education system are increasingly less able than many of those knocking on the door. The stagnation in student numbers in the 1980s, coupled with the surge of new appointments in universities and CAEs over the last 15 years, have placed educational administrators in an invidious situation in which they can make virtually no new appointments unless staff choose or are chosen to depart.

In those fields in which academics face considerable market demand the rigidity of the university salary structure tends to encourage the departure of many able and frequently entrepreneurial academics. On the other hand, for those academics who are paid more than their 'opportunity' cost (i.e. their alternative income), the effect of the uniform salary structure is to reduce the quality of academic staff below that permitted by university funding.

It may help to summarise these salient features of the current tertiary regulatory structure:

* There is a fixed set of tertiary educational institutions funded by government, largely in proportion to student numbers.
* Programs and degrees eligible for funding are determined centrally, with relatively minor scope for innovation.
* Fees, student allowances and other charges are set centrally, do not vary across institutions and fail to reflect cost and demand considerations. Even if degree A should cost 10 times degree B the student fees are the same in both cases, i.e. zero. Not surprisingly we get a chronic mismatch of supply and demand across fields.
* The bulk of academic staff have tenure, with the exception of the relatively new appointees, many of whom are more competent than their tenured colleagues. There is no capacity to negotiate risk premia in exchange for security.
* Salaries are uniform within ranks regardless of demand considerations.

Many of the features of the current regulatory structure, for example tenure, have thoroughly sensible origins - in earlier days it was vital that academic staff be free of short-term political, racial and other considerations which might influence their appointment or termination. However, other university systems, notably the United States and Canada, have found an in-between system in which tenure is negotiable after a significant period of apprenticeship and with the salaries of tenured staff varying considerably, allowing the possibility, for example, of a tenured professor earning $25,000 and an untenured lecturer earning, say, $30,000.

An essential feature of any move towards deregulation of tertiary education is that universities be given the capacity to set fees on a basis which makes efficient use of their resources and which encourages students to make appropriate decisions regarding their education and subsequent careers. To my mind an interesting experiment within the tertiary system would be for governments to allow universities to impose any fee structures they see fit, with fees, if desired, varying considerably across departments and with, say, two-thirds of the revenue so obtained retained by the university.

If current government funding arrangements were unchanged then university funds would be increased, the government would receive one-third of the fees raised, and students would face more relevant signals regarding the costs of their private educational decisions. While this 'proposal' is a typical second or third best arrangement for the restructuring of education, it would nevertheless seem to me to be a possible and worthwhile innovation which would start to bring a little bit of the market into an over-regulated and government dominated tertiary education system.

IV. SUMMARY

We have contrasted the role of the private sector entrepreneur with that of the static optimising bureaucrat obliged to work under rigid rules and with a resulting limited vision of the future of 'his' state enterprise. Whereas change characterises the entrepreneurial function, static efficiency, stability and predictability are regarded as desirable features of the efficient worker in state enterprise. We have noted that many industries currently under considerable criticism in Australian society - communications, transportation, power and education - are ones in which the entrepreneurial spirit has been largely regulated out of existence. If we are to succeed in facilitating desirable social change we need to foster entrepreneurship and so allow private initiative to play an increasing role in these critical areas. While we cannot completely rule out a role for public ownership - and while it may be possible to apply welfare economics to devise pricing rules and incentive schemes which encourage state run institutions to be both efficient and foster desirable change - the burden of recent evidence suggests to me that we will do better to place greater reliance in private ownership and entrepreneurial initiatives. As Littlechild has noted:

> The market mechanism is thus a process of discovery, a process of conjecture and experiment, a search for new and better ways of meeting customers' wishes. If this market mechanism is to be replaced by a nationalised industry (and even if this is done because it is thought that a natural monopoly with only negligible competition would otherwise result), some provision must be made for encouraging this discovery process by the industry. The rules about marginal-cost pricing and investment appraisal do not presume to meet this task. They refer to a specified set of alternatives

> available; they do not prescribe how these alternatives are to be generated. In other words, the concept of entrepreneurial altertness to new opportunities is completely absent from welfare economics.[5]

We not only need to restore the role of the entrepreneur in the economy, we need to give him or her a more central role in economic theory.

Notes

1. I. Kirzner, *Competition and Entrepreneurship*, University of Chicago Press, Chicago, 1973, p. 48.
2. It has to be conceded, however, that there are a few examples of relatively entrepreneurial state enterprises (e.g. in France). These may indicate not the success of state control, but rather of state systems which incorporate private sector incentive structures.
3. This section is adapted from M.G. Porter, 'On the Deregulation of Education', *Economic Papers*, Economic Society of Australia and New Zealand, Spring Forum, Sydney, September 1981.
4. The proportion of private school costs met by State and Federal governments has grown in recent years. When current policies are implemented, aid to Victorian non-government schools per pupil will equal between 45 per cent and 65 per cent of the recurrent costs of government schools (see the Statement on Guidelines, W. Fife, 4th June, 1981 and speech by N. Lacy, Victorian Parliament, 15th November, 1979).
5. S.C. Littlechild, *Elements of Telecommunications Economics*, Peter Peregrinus Ltd. (on behalf of the Institution of Electrical Engineers), London, 1979.

The Views of an Entrepreneur

Neville Kennard

In the end, entrepreneurship is experiential; it is the coal-face of capitalism. Neville Kennard was invited to participate in the forum as a businessman, to describe the difficulties faced by those who apply their entrepreneurial faculties in the marketplace.

Neville Kennard is chairman of the Kennards Hire Group which he built 'from a small family business into a less small group of companies' involved in the hire of construction and industrial equipment and motor vehicles, and in real estate development and mini-storage.

He is an ardent proponent of the competitive free market and is a member of the Board of the Centre for Independent Studies.

The Views of an Entrepreneur

Neville Kennard

I. INTRODUCTION

Kennards Hire was started by my father, a real entrepreneur, an old time horse trader and promoter, who had the advantage of having left school when he was 14 years old to go jackarooing. He owned a dairy when he was 18 and was a shearing contractor when he was 20. I didn't have the same advantage. I grew up with a fairly affluent middle class background and happened to flop into the business which my father had started. He struck on the idea of hiring equipment in 1951 and started hiring out a few concrete mixers and wheelbarrows from the garage of his house. I came into it a couple of years later, found that I didn't get on all that well with him in business and eventually managed to buy him out.

II. THE PROBLEMS FACED

Identifying a need

The problems that I've had to overcome fall into four areas and in increasing order of difficulty these are as follows: First, to identify or verify the need for a product or service. I think that is very easy. There seems to be no shortage of opportunity for entrepreneurial activity. You only have to walk down the street wanting to buy something, go somewhere or do something and you'll find examples of things that can be done better or differently, or things that haven't yet been done. I've never found that a problem. Verifying the need is just a question of doing the sums to see whether a venture makes sense on paper economically, to see whether you're going to make a quid out of it. This is of course a little difficult, with unknown factors, but I've never found it a major problem.

The acquisition of skills

The second type of problem is more difficult - the acquisition of the skills and the knowledge needed to do well the entrepreneurial tasks that one undertakes. This is not particularly hard either. The good old university of hard knocks is a great teacher and if you don't have particular skills, it is always possible to go out and buy them in the market place. It is handy though to acquire some knowledge and personal skills in communicating with people, in getting on with people, in supervising, recruiting, training and getting them to do things for you. It helps if you have some knowledge of accounting, budgeting, promoting and advertising, and in financing, borrowing and, if you're lucky enough, lending.

Bureaucracy

The next most difficult area, I've found, is the bureaucracy and the red tape that's involved with doing business. This seems to be a particular problem of mine. I'm not sure if it's because I'm doing lots of new things or if it's in my nature, but I frequently seem to have headlong confrontations with bureaucrats. I'm not very good at handling that. Patience isn't one of my virtues and I don't suffer fools gladly. I don't like the negative attitude that most of these people seem to have, and it seems that whatever you want to do, there's a bureaucrat there. Sometimes it seems there is a whole army of officials from whom you need permission to do what you want, when, where and how you want to do it.

In relation to **what** you want to do, it seems there is hardly anything a businessman can do today which doesn't require a licence. In hiring equipment, for example, we don't need a licence to actually go into the business, but we need a heap of other licences to perform certain functions in that business. In other areas, transport and communications particularly, it is almost impossible to get started. It is just not allowed. If you want to start an airline, a telephone company, a mail service, you either can't do it, or you need approval which is very difficult to get.

In other areas you're in competition with the government. I discovered this when I decided that growing pine trees might be an interesting sideline. I found that I was in competition with the government which is planting and selling pine trees and really isn't interested in making a profit. It just keeps planting them, with little regard, it seems to me, as to whether there's going to be a market there in the long term, and it cuts them down without necessarily trying to maximise its return.

If you want to build, fish, or farm, if you want to open a restaurant or a hotel, or even if you want to go into a profession, you need a licence from the government. In some cases it's just a formality but you still need the piece of paper. For a factory you need a factory licence. It doesn't do anything. You just hang it on the wall. It's only $10, but it's still got to be there.

As to **where** you want to operate, there are zoning laws and development laws and building laws and people telling you that you can't do what you want to do where you want to do it. We find this happening to us quite often. The zoning that suits us properly is industrial, but it could be commercial. Mostly, when we start a new hire branch, the proposed location is zoned industrial. We go to the local council, whose knee-jerk reaction is: 'You should be in a commercial area.' Of course if I go along wanting to apply in a commercial area, they'll almost certainly say I should be in an industrial area. To one particular council which said 'We think that's a commercial activity', I pointed out that I wouldn't find three acres in the main street of Parramatta and that with the storing of equipment, its maintenance and the necessity of starting up engines, it may not be the best activity for a main street. I was told that I would have to store equipment in one place and hire it from another. That was a lower-rung bureaucrat and up the ladder a bit they did become more reasonable.

Next door to our site in Artarmon there was a store that sold timber and hardware. They were trading extremely well. We liked them there because they were complementary to our business, but the council closed them down because they were retailing in an industrial area. Their customers hadn't minded them where they were and I don't know of anyone who objected except the planners.

As to **when** you open your business, there are trading laws that determine what times of the day and the week that you can do things. In our business we can hire 24 hours a day, seven days a week, but we can't sell after midday Saturday. When we hire a floor sander, we usually sell the paper that goes with it, but according to the NSW Department of Industrial Relations, after noon on Saturday we have to fence off the area where we sell the paper so people can't buy it. There are lots of things that can't be sold after midday Saturday. You can buy a screw for your boat but not a screw to fix your back gate.

There is an interesting rule permitting family businesses to trade seven days a week - a concession to small business. The family business is described as one not having more than two employees and two family members working full time. That means if you start your business with your family and two employees and you're successful and need to expand, you have to close on Saturdays and Sundays. The logic of it eludes me.

Regarding **how** you do business, there are all sorts of rules and regulations you have to conform to. If you build the better mouse trap, before the world will be allowed to beat a pathway to your door, the mouse trap will have to conform to all sorts of consumer standards. The RSPCA might want to know whether you're going to kill the mouse kindly. You'll probably have to conform to the Australian Standard for mouse traps, if that exists, and if it does, it is certainly going to be different from standards in the rest of the world. The unions are going to tell you who you can employ. The Department of Industrial Relations will tell you what hours they will work. You'll be told what shape and size your building will be and how many toilets and parking spaces you'll have.

To test all this, I started to list out the pieces of paper we have to go through. I identified 1,600 bits of paper we have to handle for the government every year. A lot of them are involved with vehicles - registration labels and inspection certificates - amounting to about 600 pieces of paper a year. Then we have air receivers on air compressors. Each one of those has to have a certificate and it's supposed to be inspected annually by a little guy who goes around with a hammer and taps it. This is a carry-over from the days when boilers were made with rivets. An air compressor is a pressure vessel under the definition. I asked one of these inspectors if he had ever seen one blow up and he said in his 30 years he hadn't. We have to have sign licences for all our signs. We've got to have dog licences for our guard dogs. Each place of business has a factory licence. We have certificates of incorporation hanging all over the walls. We have fuel storage licences and hoist operator's licences. If we want to put in a builder's hoist, not only does the guy who is to operate it have to have a hoist licence, but the guy who installs it has to have one. If we do rigging work with scaffolding those people have to have riggers' licences. We are supposed to have an explosive tool licence if we fire Ramset guns into walls. We have a diesel fuel tax exemption certificate, because some of our diesel fuel is used in air compressors, where it doesn't attract road tax, and some is used in vehicles, where it does. One of the funniest ones is the builder's licence which we are required to have for building jobs and extensions that we do on our own premises. I've never quite worked that out. Is there a danger we will defraud ourselves? Or is there some other purpose?

Taxation

The fourth and most difficult area, I find, is taxation. The taxation structure in Australia greatly inhibits the ability to accrue capital. The taxation level is extremely high, making it difficult for a wage earner or anyone else to accumulate capital. Once you are in business it's difficult to accumulate more to expand or buy more sophistocated equipment or to go into other fields.

Taxation rates in Australia are so confiscatory I did a brief exercise. They are very much higher than they appear. For a private company, with a pre-tax profit of (say) a hundred thousand dollars, company tax takes forty-six thousand of it. Inflation, (you can't include that if you play it by the book) in our business probably accounts for ten thousand dollars inasmuch as we're only allowed to depreciate our equipment at original purchase price. That leaves forty-four thousand after-tax profit. You then have to distribute another 50 per cent of it. If you don't distribute because you want to keep it in the business you've got to pay 50 per cent tax on 30 per cent of the balance of the fifty-four thousand, which amounts to eight thousand one hundred. In the end you've got about thirty-six thousand dollars left to plough back to expand or to improve your business. This is before the shareholders get anything.

There are all sorts of ways that people seek to avoid tax through legal tax shelters and by evasion. It is very much more difficult for private companies to accumulate capital. I see it as a great incentive to avoid tax, in fact, I was tempted to call this paper The Tax Avoidance Imperative. I think there's a natural desire to hang on to what you've made, to hang on to what's yours. There is a survival imperative. If you want to survive, if you want to stay in business, it is difficult not to seek to avoid tax. There is a great competitive force, too, for if your competitor is doing it, or you think he might be, you can't afford not to. So there are plenty of good reasons why people will, I believe, try to avoid income tax.

Then there are the other taxes that are payable. It's amazing how many there are: there's company tax; pay as you earn taxes (which we collect on behalf of the government from our employees); payroll tax (that's a terrific one, tax for employing people); sales tax (some of the things we buy are taxable, some are not, so we have to have a rule where we quote a sales tax exemption number or we don't, depending on the item, and then when the tax inspector comes out we argue about whether that rear vision mirror went on a vehicle or on a piece of construction equipment); we have land tax; and we have a hire tax (believe it or not) which is really a stamp duty. There are about 8 or 10 different stamp duties - stamp duty on real estate transactions, on cheques, on mortgage transactions, on insurance, on lease for hire purchase transactions and on purchase of vehicles. We pay import duty and sales tax when we import equipment. There are council and water rates. There are development taxes and fees and so it goes.

III. CONCLUSION

I conclude with a couple of observations on the role of the entrepreneur. Firstly, he does benefit society. He brings goods and services to the market which wouldn't otherwise be there. These result in lower prices or better services, higher employment, new ideas and he might also pay taxes to the government if he hasn't found a way not to.

Secondly, the role of entrepreneur is open to everybody. Education, colour, creed, and background are not really important to the people to whom you sell or the people from whom you buy. What matters is that you give them the service they want and you pay your money. It is a very egalitarian form of activity. I don't think people are concerned what religion their butcher or baker is.

The system as it now works, with extensive government intervention, discourages newcomers. It works for the benefit of those already in business, because it is difficult both from the financial and regulatory viewpoints for new people to get into business. The result is that those of us already in business are less innovative and less bothered by newcomers and competitors than we would be in a freer economy.

Appendix

The Primacy of Entrepreneurial Discovery

Israel M. Kirzner

This paper was originally presented in 1979 to a Colloquium organised by the Institute of Economic Affairs in London. It was published in *Prime Mover of Progress: The Entrepreneur in Capitalism and Socialism*, Institute of Economic Affairs, London, 1980. The Centre for Independent Studies is grateful to the Institute of Economic Affairs for permission to reprint.

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The Primacy of Entrepreneurial Discovery

Israel M. Kirzner

I. INTRODUCTION

An economically successful society is one whose members pursue the 'right' set of coordinated actions. The 'ideal' economic organisation for a society consists, therefore, of the pattern of institutions and incentives that will promote the pursuit of the 'correct' set of actions by its members. Economic theory has, in general terms, been able to enunciate the conditions to be fulfilled if a set of actions is to be 'correct'. These optimality conditions are, not surprisingly, governed basically by the available resources and technological possibilities, on the one hand, and, on the other, by the pattern of consumers' tastes. The 'economic problem' faced by society is then often viewed as being somehow to ensure that the various economic agents in society indeed undertake those actions that will, altogether, satisfy the conditions for optimality. While this formulation is in some respects not quite satisfactory, it will serve reasonably well in introducing our discussion of the role of entrepreneurial discovery.

II. PATTERNS OF ECONOMIC ORGANISATION

In theory there exists a variety of possible patterns of economic organisation for society, ranging from completely centralised decision-making at one extreme, through an array of 'mixed' systems, to pure laissez-faire. Several related observations may be made.

First, **all** these possible systems of economic organisation involve making **decisions** - with greater or lesser degree of decentralisation. Second, these decisions will necessarily involve an **entrepreneurial element** - regardless of the degree of decentralisation sought. Third, one dimension along which the effectiveness of each of the alternative patterns of societal economic organisation will need to be assessed, will therefore be that of measuring the **success** with which entrepreneurial activity can be evoked in that pattern of organisation. These observations call for some elaboration.

1. The Entrepreneurial Element in Decisions

We have asserted that decisions necessarily involve an entrepreneurial element. What do we mean by the 'entrepreneurial element' in decision?

The non-entrepreneurial element in decisions is easy to pin down. In most textbooks of microeconomics, this non-entrepreneurial element is often made to appear the **only** element in decision-making. The non-entrepreneurial element in decision-making consists of the task of calculation. A decision-maker is, in this context, seen as seeking to achieve an array of goals (or to 'maximise' some goal or utility function) with the scarce resources available. In seeking to arrive at the optimal decision, the decision-maker must therefore calculate the solution to what, in the jargon of economics, is called a 'constrained maximisation problem' (i.e. the problem of achieving maximum desirable results without overstepping the constraints imposed by the limited resources available)[1]. Correct decision-making, in this non-entrepreneurial sense, means correct calculation; faulty decision-making is equivalent to mistakes in arithmetic.

This non-entrepreneurial aspect does not have to assume initial omniscience; it is entirely possible for the incompletely informed decision-maker to calculate (i.e. to decide) how much knowledge to acquire.[2] But this non-entrepreneurial aspect does presume, at least, that the decision-maker has a clear perception of the scope of his ignorance, and of how this ignorance can be reduced; in a sense he knows precisely what it is that he does not know. And it is here that we can recognise the scope for the other element in decision-making, the entrepreneurial element.

For the truth is that the calculative aspect is far from being the most obvious and most important element in decisions. When a wrong decision has been made, the error is unlikely to have been a mistake in calculation. It is far more likely to have resulted from an erroneous assessment of the situation - in being over-optimistic about the availability of means, or about the outcomes to be expected of given actions; in pessimistically under-estimating the means at one's disposal, or the results to be expected from specific courses of action. Making the 'right' decision, therefore, calls for far more than the correct mathematical calculation; it calls for a shrewd and wise assessment of the realities (both present and future) within the context of which the decision must be taken. It is with this aspect of decision that we will be dealing in analysing the entrepreneurial element in subsequent discussion.

No matter how centralised or decentralised a decision-making system may be, its decision-makers will regret their decisions if the entrepreneurship embodied in these decisions is of poor quality. Whatever the institutional context, a correct decision calls for reading the situation correctly; it calls for recognising the true possibilities and for refusing to be deluded into seeing possibilities where none exist; it requires that true possibilities should not be overlooked, but that true limitations not be overlooked either. It is therefore our contention that alternative systems of economic organisations have to be appraised, in part, with an eye to the respective success with which they can evoke entrepreneurship of high quality.

2. Entrepreneurship in Received Economic Theory

It is by now fairly well recognised that standard economic theory has developed along lines that virtually exclude the entrepreneurial role. This has largely been a result of the tendencies, long dominant in neoclassical economics, to exclude all elements of unexpected change, to focus attention almost exclusively on equilibrium states of affairs, and to treat individual decisions as immune from the hazards of error.[3]

As Frank Knight of Chicago explained many years ago, in a world from which the troublesome demon of unexpected change has been exorcised, it is not difficult to imagine away any need for entrepreneurship.[4] In such a world we can reasonably expect decision-makers, given sufficient time, to have come somehow to perceive the world correctly. To decide, in such a world, involves nothing more than to perform those calculations which we have described as constituting the non-entrepreneurial element in decision-making.

In a world of unchanging certainty, where the future unfolding of events is anticipated with assurance and accuracy, selecting the optimal course of action is not a task which challenges the entrepreneurial qualities of vision, daring, and determination. Indeed, it is difficult to imagine how such a world could ever fail to be in anything but a state of optimality. To be sure, such a world must be envisaged as bounded by resource scarcities. But it is difficult to imagine how anyone in such a world - given these resource limitations, and given the accepted structure of ownership - can ascribe any perceived shortcomings to faulty decision-making. Such an imaginary world is not paradise, but it can hardly fail to be the closest to paradise imaginable within the given limitations of supply and the given institutional framework.

When this theoretical framework is uncritically adopted, it becomes easy to fall into the error of tackling economic problems with non-entrepreneurial analytical tools. It becomes natural to assume that the correct decisions are being made, from the viewpoint of the relevant decision-makers; that the problems encountered are to be attributed to inadequate resources or to a faulty institutional structure. What is overlooked, in such treatments, is the possibility that a great deal of want and misery are the result of nothing less mundane than **sheer error** on the part of decision-makers, that is, of decisions made that, from the decision-maker's **own** point of view, are sub-optimal. That such errors may and do occur requires us to recognise scope for entrepreneurial error, for decisions made with faulty assessments of the facts of the world, future as well as present, upon which the decision is to impinge.

Certainly, in a perspective which simply assumes that decision-makers, under all circumstances, regardless of institutional environment, inevitably and unerringly find their way to the correct decisions - there is little point in inquiring into the circumstances that are most conducive to alert, entrepreneurially-successful decision-making. It is a fundamental insight that simply to assume correct decision-making is to beg far too large a fraction of the essential question confronting us. We begin, in other words, with a healthy awareness that the world is very far from being the best of all possible worlds - even from being the best of those worlds possible with available resources, and within existing institutional environments.

It is from this beginning that we are led to appreciate the primordial importance of our question: What institutional circumstances or arrangements, which system of economic and political institutions, can be expected most successfully to evoke those qualities of entrepreneurial alertness upon which the quest for optimality in decision-making necessarily depends?

3. Entrepreneurship as a Scarce Resource

It might perhaps be argued that, important as the quality of entrepreneurship undoubtedly is, it does not involve any really new considerations beyond those usually taken into account in studying the conditions for optimality. All that has been established in the preceding pages, it may be held, is merely that we must bear in mind the need for a special resource, entrepreneurship, which has often been incorrectly taken for granted. Instead of viewing entrepreneurship as exercised flawlessly, tirelessly, and universally, we must begin to recognise that it is a scarce, valuable resource of which our economic models had better begin to take careful account. But all this, it may perhaps be maintained, does not justify our demand that we transcend the standard maximising model of decision-making. All that has to be done, it may be contended, is to incorporate into our list of required resources the flow of required entrepreneurial services, and to ensure that available stocks of such service flows be used optimally. Social optimality, it may be contended, will now be judged within a broader framework in which there is recognition of both the demand for, and availability of, the service of entrepreneurial vision.

More particularly, in respect of the question we have described as primordial, it may be objected that it is fundamentally inappropriate to inquire into the comparative effectiveness of alternative institutional frameworks, for the evocation of entrepreneurship. It will be objected that, since entrepreneurship is a resource no different, for pure theory, from other resources, any comparison among alternative social economic systems must begin with the assumption of some **given** initial stock of that resource. It will not do to begin a comparison between different economic systems by suggesting that the very pattern of institutional arrangement may have important implications for the initial size of a particular stock of resource. Different economic systems may certainly differ in the efficiency with which they deploy and allocate given resource supplies; but, it may be argued, if we postulate some given supply of a particular resource in one economic system, there can be no objection in principle to supposing any other system to begin with exactly the same supply of that resource.

Our response to this line of argument (and thus our defence of the validity of the central question to be addressed here) rests on the insight that entrepreneurship cannot usefully be treated simply as a resource, similar in principle to the other resources available to an economic system.

III. THE PRIMACY OF ENTREPRENEURSHIP

What is important is to insist that entrepreneurial alertness differs in fundamental respects from the resources ordinarily discussed in decision-making. These differences will justify our contention that there may be important differences between different economic systems in respect of their success in harnessing entrepreneurial alertness for making error-free decisions.

A cardinal quality of a potential resource, in the economists' analysis of decisions, is that the decision-maker can deploy it, if he so chooses, in specific processes geared toward the achievement of specified goals. What the decision-maker has to decide is whether to deploy a particular resource, how and in what quantity to deploy it. He must decide whether to use it at all, whether to use it for one purpose or for another. The quality of entrepreneurial alertness cannot be discussed in these terms.

Entrepreneurial alertness is not a conventional economic resource

If an entrepreneur's discovery of a lucrative arbitrage opportunity galvanises him into immediate action to capture the perceived gain, it will not do to describe the situation as one in which the entrepreneur has 'decided' to use his alertness in order to capture this gain. He has not 'deployed' his hunch for a specific purpose; **rather, his hunch has propelled him to make his entrepreneurial purchase and sale.** The entrepreneur never sees his hunches as potential inputs about which he must decide whether or not they are to be used. To decide **not** to use a hunch means - if it means anything at all - that a businessman realises that he has no hunch (or that his hunch is that it will be best to be inactive for the time being). If one has become sufficiently alerted to the existence of an opportunity - i.e., if one has become sufficiently convinced regarding the facts of a situation - it becomes virtually impossible to imagine **not** taking advantage of the opportunity so discovered.

Entrepreneurship is thus not something to be deliberately introduced into a potential production process; it is, instead, something primordial to the very idea of a potential production process availing possible implementation. Entrepreneurial alertness is not an ingredient **to be deployed** in the decision-making; it is rather something in which **the decision itself is embedded** and without which it would be unthinkable.

It is true that **knowledge** (e.g., in the sense of technical expertise) may be deployed. A person may certainly decide that it does *not* pay to use his knowledge in a specific manner. Or he may decide that it does pay to use it. Here knowledge is a resource at the disposal of the entrepreneur. He is conscious of his knowledge as something to be used or not. But this refers only to knowledge of how to achieve specific goals, not knowledge of whether or not it is worthwhile to attempt to achieve a goal altogether. A distinguishing feature of entrepreneurial insight consists precisely in the absence of self-awareness by its possessor that he does possess it. A would-be entrepreneur may agonise over whether or not to embark on a particular venture. His trauma arises not from deciding whether or not to use his entrepreneurial vision; it stems from his unsureness of what he 'sees'.

Entrepreneurial opportunity may be blocked by lack of a resource but not of insight

Again, it is integral to a necessary resource (in the usual sense) that a decision-maker may feel its lack. A decision-maker may say: 'I have all the ingredients necessary to produce ice-cream, except sugar'. The opportunity to achieve a particular goal is blocked only by lack of some necessary resource. But it is absurd to imagine a decision-maker saying (on a commercial venture about the profitability of which he is profoundly sceptical) that he sees a profitable opportunity the exploitation of which is blocked only by lack of entrepreneurial insight. It would be absurd because this entrepreneur is (correctly or otherwise) convinced that he does **not** see any profitable opportunity in this venture at all.

To repeat what was stated earlier, all this does not apply to **technical** knowledge which an entrepreneur may know exists and which he knows he lacks. It is certainly possible for a decision-maker to say: 'I have all the ingredients for ice-cream, but I lack the relevant recipe'. He may know that a recipe exists, and that it is a good one, without knowing what it is. But for a man to refrain from a particular productive venture because he is not convinced that it is sound - even if it turns out that he was wrong - is not to refrain from it because he has been unable to lay hands on the appropriate vision; it is to refrain because he is convinced (rightly or wrongly) that, with respect to this venture, the **best entrepreneurial alertness finds nothing to be seen.**

Entrepreneurial alertness is not a potential stock available to society

It is because of this inherent **primacy** of entrepreneurial alertness and vision (as contrasted with deployable resources)[5] that we cannot avoid the question to be addressed in this paper - the varying degrees of success with which alternative economic systems can inspire entrepreneurial alertness. We do not view the **potential** stock of entrepreneurial alertness in a society as some quantity 'available to be used by society'. (Were this the case one could proceed to inquire how different systems variously succeed in most effectively using this uniformly **given** stock.) Instead we recognise the quality of entrepreneurial alertness as something which **somehow emerges into view at the precise moment when decisions have to be made.** As we shall see (VII), this opens up the important possibility that the institutional framework within which decisions are made may itself vitally affect the alertness out of which those decisions emerge.

IV. THE COST OF ENTREPRENEURSHIP

This line of argument points to a further related insight: **entrepreneurship is costless.** In using any quantity of a scarce resource (in the usual sense of that term) the decision-maker is always viewed as choosing between alternative goals to which the scarce resource might be applied. The goal foregone is the cost of using the resource for its present purpose. In the case of entrepreneurial alertness, however, a decision-maker never considers whether to apply some given potential alertness to the discovery of opportunity A or opportunity B. As already argued, the opportunities (or any one of them) are either perceived or they are not perceived; alertness is not something about which a decision can be made **not** to deploy it. (In this we distinguish sharply between pure alertness, on the one hand, and 'deployable' scarce inputs that may be useful in decision-making, e.g., time, technical knowledge, managerial expertise, on the other.) To recognise that opportunity A exists need not preclude simultaneously recognising that opportunity B exists.

Conversely, to fail to recognise that opportunity A exists cannot be explained in terms of the high cost of so recognising it; if opportunity A has not been recognised, the failure represents some short-coming in entrepreneurial alertness, not the outcome of a decision to deploy it for the discovery of other opportunities.

Faulty entrepreneurship means alertness remains untapped

That in the real world we encounter innumerable instances of faulty and inadequate entrepreneurship must be interpreted, therefore, not as evidence of the absolute scarcity of entrepreneurial alertness (with the existing stock of it having been applied elsewhere), but as evidence that the alertness costlessly available has somehow remained latent and untapped. The central question then looms even more significantly than ever: What institutional frameworks are best suited to tap the reservoir of entrepreneurial alertness which is certainly present - in potentially inexhaustible supply - among the members of society?

V. THE QUALITIES OF ENTREPRENEURSHIP - THE UNCHARTED FRONTIER

Although, as Ludwig von Mises pointed out long ago,[8] all individual action is entrepreneurial, and although we have described entrepreneurial alertness as in principle inexhaustible, we have also been careful to notice that potential alertness may be (and so often is) untapped and inert. We know, certainly, that individuals display vastly different degrees of entrepreneurial alertness. Some are quick to spot as yet unnoticed opportunities, others notice only the opportunities revealed by the discoveries of others. In some societies, in some climates, among some groups, it appears that entrepreneurial alertness is keener than in others. Studies of economic development have come to recognise that the qualities called for in successful entrepreneurship are not uniformly distributed, and certainly do not appear to be in infinite supply.

It would certainly be desirable to be able to identify with precision those human qualities, personal and psychological, which are to be credited with successful entrepreneurial alertness, drive and initiative. It would be most valuable to be able to study the short-run and long-run impact upon the development of these 'entrepreneurial' qualities, of alternative social, economic and institutional frameworks. It would be important to know, for example, if a comfortable sense of security discourages the noticing of new opportunities. If 'independence' or 'economic freedom' encourages entrepreneurial drive and initiative, this would be significant information. Likewise, does 'competition' encourage alertness to new opportunities?

Research on psychological aspects desirable

Up to the present, little systematic work appears to have been done on these questions. Observations made are likely to be based on 'common sense' or on anecdotal foundations. It is certainly necessary to go beyond this elementary stage. Indeed, an important frontier of knowledge, largely unexplored, appears to consist of those aspects of psychology such as temperament, thirst for adventure, ambition and imagination that are likely to throw light on the development of the qualities of entrepreneurship, and on the ways in which alternative institutional arrangements may affect such development. It is to be expected and very much to be desired that research should proceed on this frontier during the years ahead.

Applied entrepreneurial theorists should look to this research with considerable interest; it is to be hoped that their own needs and interests will help to define the directions along which this research proceeds and to formulate the questions it seeks to answer.

My tentative observations here will suggest that a number of important general statements can be made even before we enjoy the systematic knowledge anticipated to emerge from research into the psychology of entrepreneurship.

VI. THE INCENTIVE FOR ENTREPRENEURIAL DISCOVERY

Were entrepreneurship a scarce resource in the usual sense, economists would have no difficulty in spelling out, at least in general terms, the kinds of incentives capable of coaxing out the desired quantity of entrepreneurial discovery. Potential entrepreneurs would have to be offered rewards that more than offset the costs of exercising entrepreneurship. This, after all, is how economists understand the role of incentives; this is how the price system is perceived to offer, via the resource market, the incentives required to stimulate resource supply and to allocate it among alternative uses. But the special aspects of entrepreneurship render this kind of incentive system inappropriate to entrepreneurial alertness and discovery.

Since entrepreneurship is costless (no incentive at all is needed, in principle, to activate entrepreneurial vision), and since on the other hand entrepreneurial vision is not uniformly and continuously 'switched on' to take advantage of all opportunities, we are very much concerned to identify what it is that **does** 'switch on' entrepreneurial vision and discovery.

With scarce resources in the usual sense, it is meaningful to talk of the kind of incentive needed to be 'offered' to owners to stimulate supply. We can imagine, that is, that some entrepreneur already has a fairly clear picture of the results to be obtained from deploying the relevant resource in some particular line of production. We can then talk of whether or not it is worthwhile for him to offer the resource price required to overcome the cost of supplying the resource. The point is that the notion of a needed incentive, in this usual sense, presupposes the clear perception, even before the deployment of the service, of its usefulness in production.

As has already been emphasised, such a perception is ruled out by definition in the case of entrepreneurial alertness. No one 'hires' or 'offers incentives' to the entrepreneur. To hire an 'entrepreneur' **is to be an entrepreneur** - simply shifting the problem back to the incentives that might galvanise **this** latter entrepreneur into action. It cannot be sufficiently emphasised that

(a) until an opportunity **has** been discovered, no one knows how much to offer as an incentive for its discovery;

(b) once the opportunity has been discovered, it is no longer relevant to inquire into the springs of entrepreneurship - since it will already have been exercised.

The promise of pure gain is entrepreneurial incentive

There seems one statement which, however, can be made about the incentives required to excite entrepreneurial alertness. It is a statement which sees such incentives as having little in common with the character of and role for incentives in the usual sense. It can be stated with considerable confidence **that human beings tend to notice that which it is in their interest to notice.** Human beings notice 'opportunities' rather than 'situations'. They notice, that is, concatenations of events, realised or prospective, which offer **pure gain.** It is not the abstract **concatenation** of these events which evokes notice; it is the circumstance that these events offer the promise of pure **gain** - broadly understood to include fame, power, prestige, even the opportunity to serve a cause or to help other individuals.

Two individuals walk through the same city block teeming with hundreds of people in a variety of garbs, with shops of different kinds, advertising signs for many goods, buildings of different architectural styles. Each of these individuals will notice a different set of items out of these countless impressions impinging on his senses. What is noticed by the one is not what is noticed by the other. The difference will not merely be one of chance. It is a difference that can be ascribed, in part, to the **interests** of the two individuals. Each tends to notice that which is of interest **to him.**

A difference between the price of apples traded in one part of the market and the price of apples traded in another part may pass unnoticed. It is less likely to pass unnoticed if it constitutes a phenomenon of interest to its potential discoverer. A concatenation of possible events (in this case the possible purchases of apples at a lower price, to be followed by their sale at a higher price) may not be noticed at all unless the potential discoverer stands to gain from the price differential. **In order to 'switch on' the alertness of a potential discoverer to socially significant opportunities, they must offer gain to the potential discoverer himself.**

This kind of incentive - the incentive that somehow converts a socially desirable opportunity into a personally gainful one - is not needed to ensure pursuit of that opportunity **after** its discovery. Once the socially desirable opportunity has been perceived, individuals may be persuaded (or threatened) to act on that opportunity simply by suitable choice of reward (or punishment). The kind of incentive here under discussion is that required to reveal opportunities that have **until now been perceived by no one at all.**

VII. PERFORMANCE OF ALTERNATIVE ECONOMIC SYSTEMS UNDER ENTREPRENEURIAL INCENTIVE

How do alternative social-economic systems appear likely to perform in terms of this kind of incentive? We will consider (a) a free market economy, (b) a centralised (socialist) economic system, (c) a regulated market economy. Our concern is solely with the comparative scope they hold for entrepreneurial incentives.

(a) Entrepreneurship in the Free Market

The free market is characterised most distinctively, for our purpose, **by freedom of entrepreneurial entry.** Given some accepted system of property rights, individual participants are free to enter into mutually beneficial trades with each other. Production decisions involve judgments about buying inputs on factor markets in order to sell output in product markets. Market prices therefore guide the decisions which determine the allocation of society's resources among alternative lines of output. Were the market to have attained full equilibrium, it may, under specific assumptions, be described as having attained an optimal allocation of resources.[7] But (especially in view of ambiguities surrounding the interpretation of 'social optimum', and of the possibility that not all the specific assumptions will be fulfilled in practice) this is **not** the interesting proposition - even were it reasonable to view the free market economy as in continuous equilibrium.

What is important about the market economy is that unexploited opportunities for reallocating resources from one (low-market-valued) use to another of higher value offer the opportunity for pure entrepreneurial gain. A misallocation of resources occurs because, so far, market participants have not noticed the price discrepancy involved. This price discrepancy presents itself as an opportunity to be exploited by its discoverer. **The most impressive aspect of the market system is the tendency for such opportunities to be discovered.**

The discovery process of the market

It is in a sense similar to this that Hayek has referred to the competitive market process as a 'discovery procedure'.[8] The essence is not that market prices offer spontaneously developed 'signals' able faultlessly to coordinate millions of independently-made decisions. (This would occur only in equilibrium; in disequilibrium the prices which prevail would **not** so perfectly coordinate decisions.) It is rather that the disequilibrium situation - in which prices do not offer the correct signals - is one which offers entrepreneurs the required incentives for the discrepancies to be noticed and corrected. In the course of this entrepreneurial process, new products may be introduced, new qualities of existing products may be developed, new methods of production may be ventured, new forms of industrial organisation, financing, marketing or tackling risk may be developed. All the ceaseless churning and agitation of the market is to be understood as the consequence of the never-ending discovery process of which the market consists.

(b) Entrepreneurship in the Socialised Economy

Little work has been done on the analysis of entrepreneurship in fully socialised societies. The great debate on economic calculation under socialism carried on between the two world wars, in many respects revolved precisely around this issue, but was couched in terms which unfortunately permitted the central importance of this issue to be overlooked. The attempts by Oskar Lange (of Poland) and others to show how a socialist system could be set up that would permit decentralised decisions by managers of socialist enterprises on the basis of centrally promulgated 'prices', along the same lines as the price system under the free market, unfortunately completely overlooked the entrepreneurial character of the price system.

Lange relied on the so-called 'parametric function' of prices, i.e., on that aspect of prices which permits each decision-maker to treat them as equilibrium prices to which he must passively adjust himself.[8] But in this view of the market (and hence of the possibility of a socialist 'price' system), Lange failed to recognise that the distinctive aspect of the market is the manner in which prices **change**, i.e. that market prices are in fact treated non-parametrically. It is one thing to imagine that socialist managers can be motivated to obey rules on the basis of centrally promulgated 'prices'; it is quite another to take it for granted that the **non**-parametric function of price (in which, that is, price is **not** being treated as a datum but subject to change by individual market participants), a function which depends entirely on entrepreneurial discovery of **new** opportunities for pure profit, can be simulated in a system from which the private entrepreneurial function is completely absent.

Alertness by 'price' planners and plant managers

Under a Lange-type system, alertness would be called for at a number of levels. Officials deciding on the 'price' structure must do so by what they know about the performance of the economy under earlier 'price' structures, and by what they anticipate to be the pattern of consumer demand and of resource supply in the period ahead. In promulgating a list of 'prices' it is necessary to determine, first of all, the list of commodities and of resource services for which 'prices' are to be set. The construction of this list requires an enormous volume of entrepreneurial alertness on the part of these officials. After all, some products should not be produced at all; others very definitely ought to be produced, but officials may be quite ignorant of them or of their urgency. This will of course be more particularly likely to be true of new and innovative products and product qualities. But it could occur with any product whatever.

Again, the Lange system would call for alertness by socialist plant managers. They would have to identify sources of resource supply; they would have to notice technological possibilities that may not hitherto have been economic. They would have to notice the need for and possibility of any number of changes (innovative or otherwise) which changed patterns of tastes, for example, might make worthwhile. There is certainly nothing in Lange's own description of his system to suggest how this might be ensured.

Will available options be noticed? How?

The question which the entrepreneurial theorist must ask is not whether, given available known options, the relevant socialist official is operating under an incentive system that will make it personally gainful for him to select the optimal course of action for society. Our question is rather whether there is any assurance that relevant options will in practice be noticed as being available. What might motivate an official to notice an opportunity not yet adopted (but which it might be highly valuable to pursue)? It will not do to suggest that some higher official arrange matters so that, when the (lower) official does notice the opportunity, he can personally benefit by its adoption. This merely passes our question up the line: What might motivate this higher official to notice the opportunity? - and even to notice its worthwhileness **after** it has been brought to his attention?

We will, for the present, ignore the question of how a newly discovered valuable social opportunity is revealed, even after the event, as having been such. Our question will confine itself to asking how it might be ensured that such social opportunities constitute at the same time privately gainful opportunities for their potential discoverers. It is doubtful in the extreme if ideals such as benevolence or patriotism can be relied upon, in general, to enable a potential discoverer to identify his own personal interest with that of the discovery of an opportunity for a desirable re-allocation of resources for society.

We might imagine, of course, a system in which there is not merely decentralisation of decision-making, in the Lange sense, but also freedom for socialist managers to buy and sell on behalf of the state (when discrepancies among socialist 'prices' might have been discovered) and to retain for themselves some fraction of the price-differential. If such trading is restricted to those who are already socialist managers, we will have to examine the mechanism of selection of managers to see whether it indeed ensures that those with entrepreneurial skills tend to become socialist managers (since the socialist state would not be permitting others to 'prove' their entrepreneurial skills in this way). On the other hand, if entrepreneurial trading is to be open for all (raising, let us of course note, the obvious question of access to society's capital to be risked in such ventures), then clearly we have moved closer and closer toward a 'mixed' capitalist system in which private entrepreneurs might be free to seek profits within a system of state-controlled prices (a regulated system which will be briefly considered at (c) below).

Individual decision-makers cannot profit under 'market' socialist schemes

We may talk of various schemes for 'market' socialism along Lange lines, in which some decisions are left to lower-ranking officials to be made on the basis of centrally-designed systems of 'prices'. No matter how extensive the degree of decentralisation thus achieved, however, a critical condition for the socialist quality of the system appears to be that neither at the level of the central design of 'prices', nor of individual-manager decisions made on the basis of these 'prices', may decisions be made primarily in order that the decision-taker can profit personally from errors discovered. Those responsible for designing the system of socialist 'prices' are clearly not participants in any entrepreneurial market; their function is to impose 'prices' upon the socialist 'market'.

To imagine that in this socialist 'market', freedom of entry for private profit-making entrepreneurial activity is to be permitted, is surely to compromise fatally the definition of a socialist economic system. But without such freedom of entrepreneurial entry market-socialism has a fatal flaw: it has not succeeded in identifying any way by which errors, whether of omission or commission, can be systematically avoided by decision-makers. It has not identified any way by which the discovery and avoidance of error rebounds directly to the personal benefit of the discoverer. It has not identified how the unsuspectedly inefficient socialist venture might so reveal itself to a socialist decision-maker in advance as a threat to his own well-being; it has not identified how the currently undreamed-of venture, of critical benefit to society, might reveal itself to a socialist planner as one offering him personal gain.

Incentives to socialist managers deny essential role of entrepreneurial discovery

We do not deny the possibility of arranging incentives to socialist managers to produce more, or to produce with a smaller labour force, or lower energy consumption. Nor do we even deny the possibility of offering incentives that will reward innovation. Incentives can certainly be structured to reward inventors and innovators of new products and new production techniques. Recent extensive study of innovation in the Soviet Union has, for example, confirmed the significant vitality of the innovative process there (although the process lags more or less behind that in capitalist economies).[18] But to reward managers for meeting or exceeding target output quantities presupposes that **it is already known** that more of these outputs is urgently required by society; to reward managers for introducing a new product is to presume that **it is already known** that this particular new product - or else that **any** new product - is socially more important (taking into account the resources required for its production) than the product it replaces; to reward managers for introducing innovative methods of production is to presume that **it is already known** that the additional inputs called for by the new technique are less costly to society than those the technique avoids - or else that **any** change in production technique must be an improvement over those currently employed.

That these matters may already be known is in many instances entirely plausible. But if they **are** assumed already known, we are simply assuming away the need for entrepreneurial discovery. The task is to ensure the discovery - by someone, somewhere, who possesses power to set things in motion - of which products (existing or new) should be produced (and in what quantities), the urgency of which the currently conventional wisdom has **failed** to recognise. The problem is to identify techniques of production the usefulness of which has up until now **not** been perceived. Not all innovation is socially desirable; not all expansion of lines of output is socially desirable. What is required is an incentive system to convince decision-makers that when they discover opportunities which others will deny to exist, they (the discoverers) will be the gainers.

Thus far, in all the discussion of varieties of socialism, of incentive systems and planning theories, we have not seen **this** problem addressed. Nor is it at all apparent how, without fundamentally compromising the essential defining criteria for socialism, it can be solved.

(c) Entrepreneurship in the Regulated Market Economy[11]

Most societies in the modern world have allowed their economic systems to follow the pattern neither of pure socialism nor of pure capitalism. They consist of market economies that have been circumscribed by more or less extensive systems of state intervention. Convinced that the unhampered market will generate undesirable price structures, or undesirable arrays of output qualities, working conditions, or other undesirables, the state intervened, replacing the laissez-faire market by the regulated market. Price ceilings and price and wage floors, transfer of income, imposed safety standards, child labour laws, zoning laws, prohibited industrial integration, prohibited competition, imposed health warnings, compulsory old-age pensions and prohibited drugs, are among the countless controls that possibly well-meaning public officials impose. What is the role of entrepreneurial discovery in the regulated market?

Genuine - but inhibited - entrepreneurial incentive.

Despite the controls, regulations and interventions, there exist, in such systems, genuine markets for both resource services and consumer products. Although the prices which emerge in regulated markets may have been more or less drastically distorted in the regulatory process, they are (except for directly controlled prices) nonetheless market prices. To the extent that entrepreneurial entry remains free, discrepancies in these prices provide the incentives for entrepreneurs to capture pure profit, leading to a process of entrepreneurial competition acting at all times to modify the existing price structure.

Nevertheless, it is not difficult to perceive the many ways in which entrepreneurial discovery may come to be inhibited or redirected under regulatory constraints. And regulation raises new and important questions concerning the way in which the agents of the state (whether legislators or officials in other stages of regulation and its enforcement) come to notice where opportunities for supposedly beneficial regulation may exist. Let us take up these latter questions first.

Knowledge and discovery absent in price setting and resource allocation

Government regulation takes the general form of imposed price floors, price ceilings, mandated quality specifications, and similar measures. We will assume that the hope surrounding such governmental impositions is that they will confine market activities to desired channels and at desired levels. But it is by no means clear how officials will know what prices to set, or if their earlier decisions have been in error. It is not clear how officials will **discover** those opportunities for improving the allocation of resources (which, after all, we can hardly assume to be automatically known at the outset of a regulatory endeavour). The regulator's estimates of the prices consumers are prepared to pay, or of the prices resource owners are prepared to accept, are not **profit-motivated** estimates. But estimates of market demand conditions, or of market supply conditions, that are not profit-motivated cannot reflect the powerful, discovery-inspiring incentives of the entrepreneurial quest for profit.

It is, further, not clear how it can be ensured that government officials who perceive market conditions more accurately than others, will tend systematically to replace less competent regulators. It is not clear what proxy for entrepreneurial profit and loss there might be, that could inspire officials to see personal gain for themselves in successful discovery. What regulators know (or believe they know) at a given moment is presumably only partly correct. No systematic process seems available through which regulators might come to discover that which they have not known, especially since they have not known that they enjoy less than complete awareness of relevant situations. **If they do not know what they do not know, how will they know what remains to be discovered?**

Quite apart from the question of the entrepreneurship required to engage in regulation believed to be desirable, we must, in the context of the regulated market economy, also consider the impact of regulation upon the pattern and direction of entrepreneurial discovery in the marketplace. There is a serious likelihood that regulatory constraints may bar the discovery of pure profit opportunities (and thus of possibilities for socially beneficial resource reallocation).

Damaging effects of regulatory controls and price ceilings

A good deal of regulation consists in creating **barriers to entry.** Tariffs, licensing requirements, labour legislation, airline regulation, and bank regulation, for example, do not merely limit numbers in particular markets. These kinds of regulatory activity tend to bar entry to entrepreneurs who believe they have discovered profit opportunities in barred areas of the market. Such barriers may, be removing the personal gain which entrepreneurs might have reaped by their discoveries, bring it about that **some opportunities may simply not be discovered by anyone.** An entrepreneur who knows that he will not be able to enter the banking business may simply not notice opportunities in the banking field that might otherwise have seemed obvious to him; those who are already in banking, and who have failed to see these opportunities, may continue to overlook them. Protection from entrepreneurial competition does not provide any spur to entrepeneurial discovery.

Imposed price ceilings may, similarly, not merely generate discoordination in the markets for existing goods and services (as is of course well recognised in the theory of price controls); they may inhibit the discovery of wholly new opportunities. A price ceiling does not merely block the upper reaches of a given supply curve - further increases in supply to meet demand. It may also inhibit the discovery of as yet unsuspected sources of supply (which in the absence of the ceiling might have shifted the entire supply curve to the right - made supplies marketable at lower prices - as these sources came to be discovered), or of wholly unknown new products.

The imposition of price ceilings, which has switched off the lure of pure profits in this way, is not accompanied, as far as can be seen, by any device that might, in some alternative manner, lead a potential discoverer to associate a discovery with his own personal gain.

VIII. CONCLUSION

Our discussion has focussed attention on a neglected aspect of economic decision-making, the urgency for incentives for the 'entrepreneurial' discovery of what opportunities exist for economic action. Pursuing this point further, we have pointed to the need for critical assessment, within any economic system of organisation, of the way in which the system permits the potential discoverers to identify their own personal interest with the successful discovery of socially desirable opportunities for change. In the briefest possible framework, we have considered aspects of the socialist system, and of the regulated market economy, in contrast to the laissez-faire market system.

A great deal of work is waiting to be done in the economics of entrepreneurship. It has been my purpose to emphasise the enormous stake whch society - under whatever economic system it may operate - holds in the successful pursuit of such research.

Notes

1. This emphasis on maximisation is to be traced to the influence of Lord Robbins, *The Nature and Significance of Economic Science*, Macmillan, London, 1932.
2. The literature on the economics of search proceeds on this basis. The classic article is G.J. Stigler, 'The Economics of Information', *Journal of Political Economy*, June 1961, pp. 213-25.
3. An elaboration of this theme is in the author's *Competition and Entrepreneurship*, University of Chicago Press, Chicago and London, 1973, Chapters 1-3.
4. F.H. Knight, *Risk, Uncertainty and Profit*, Houghton Mifflin, Boston, 1921.
5. A fuller discussion of this insight is in the author's *Perception, Opportunity and Profit*, University of Chicago Press, Chicago and London, 1979, Chapters 9, 10.
6. In *Human Action*, Yale University Press, New Haven, 1949, p. 253.
7. A complete discussion of this central theorem of welfare economics in W.J. Baumol, *Economic Theory and Operations Analysis*, Prentice Hall, Englewood Cliffs, New Jersey, 4th Edition, 1977, Chapter 21.
8. F.A. Hayek, 'Competition as a Discovery Procedure', in *New Studies in Philosophy, Politics, Economics and the History of Ideas*, University of Chicago Press, Chicago, and Routledge & Kegan Paul, London, 1978.
9. Oskar Lange, 'On the Economic Theory of Socialism', in Lange and Fred. M. Taylor, *On the Economic Theory of Socialism*, ed. Benjamin E. Lippincott, McGraw-Hill, New York, 1964, p.70. The initial statement by Mises, demonstrating the problems in socialist economic calculation, was 'Die Wirtschaftsrechnung im sozialistischen Gemeinwesen', *Archiv fur Sozialwissenschaften und Sozialpolitik* (April 1920), translated in Friedrich A Hayek (ed.), *Collectivist Economic Planning*, Routledge and Kegan Paul, 1935. Hayek's own response to Lange is contained in his *Individualism and Economic Order*, Routledge and Kegan Paul, London, 1949.
10. Joseph S. Berliner, *The Innovation Decision in Soviet Industry*, The MIT Press, Cambridge, Mass., 1976.
11. Further discussion of this theme is in the author's *The Perils of Regulation: A Market-Process Approach*, Occasional Paper of the Law and Economics Center of the University of Miami School of Law, 1978.

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