

ThinkBox

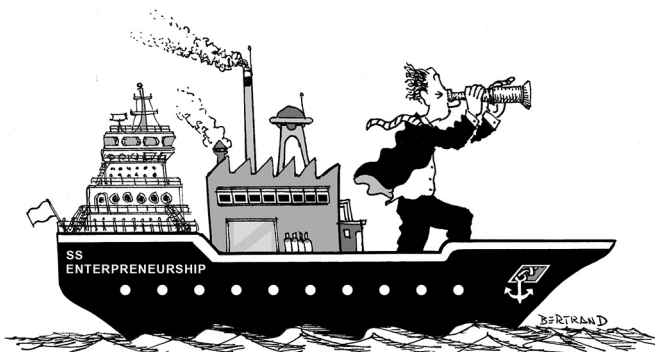
Why entrepreneurs need firms, and the theory of the firm needs entrepreneurship theory

Peter G. Klein^{a,b}^a Department of Entrepreneurship, Baylor University, Waco, United States^b Department of Strategy and Management, Norwegian School of Economics, Bergen, Norway**Abstract**

Firms are established by entrepreneurs, and entrepreneurship is typically embodied within a firm. And yet, the research literatures on entrepreneurship and the theory of the firm developed mostly independently. I suggest some reasons why these literatures have struggled to connect, and offer a potential path forward, one that describes the entrepreneurial act as the acquisition, combination, and recombination of heterogeneous resources under conditions of uncertainty.

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**Introduction**

The research literature on the economic theory of the firm has been around since the 1930s (Coase, 1937), blossoming fully into a distinct research program during the 1970s with the seminal works of Williamson (1971, 1975, 1979), Alchian and Demsetz (1972), Jensen and Meckling (1976), Holmström (1979), and many others. This story has been told many times (e.g., Foss & Klein, 2012, chapter 6) and chapters on the “theory

of the firm” appear in the leading textbooks and survey volumes. These theories focus on the benefits and costs of organizing, managing, and governing transactions [sometimes to the neglect of production costs (Langlois & Foss, 1999)] under various conditions. These perspectives have spawned a large set of theoretical and empirical applications, extensions, and refinements, and increasingly use the language and style of contemporary formal economics (e.g., Aghion, Dewatripont, Legros, & Zingales, 2016).

And yet, there is much less work in this tradition explaining the *emergence* of the firm.¹ Where do firms come from? Most are established by entrepreneurs, and indeed, the most common definition of “entrepreneur” for academics and practitioners is “one who forms a new business organization.” One would then think that entrepreneurship theory would be part of the theory of the firm. Put differently, entrepreneurs are individuals who establish, operate, reconfigure, dissolve, and otherwise work through firms; hence economic theories of the firm – as well as theories of the firm drawn from psychology, sociology, operations research, and so on – might be considered applications of entrepreneurship theory. Alas, neither is true; for the entrepreneurship field has its own research literature, largely divorced from the literatures on firm organization and firm strategy. The entrepreneurship

E-mail: Peter.Klein@baylor.edu

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¹ A recent exception is Bylund (2015).

literature focuses mostly on individuals, not organizations, and on firm creation, not firm operation.²

Much of my own recent work on entrepreneurship (see Klein, 2017) can be understood as a call to bring entrepreneurship into the theory of the firm, and the theory of the firm into entrepreneurship. Contemporary entrepreneurship research revolves around the concept of the “opportunity” (largely based on the work of economist Israel Kirzner).³ In this approach, entrepreneurship research asks why, when and how (1) entrepreneurial opportunities arise, (2) certain individuals and firms and not others discover and exploit opportunities, and (3) different modes of action are used to exploit those opportunities (Shane & Venkataraman, 2000: 218). The opportunity-discovery approach has spawned an ambitious and sweeping research program on the nature and implications of opportunities and their relationship to individual and market characteristics.

During the last decade, however, the opportunity-discovery approach has been challenged on ontological, epistemic, and methodological grounds. Alvarez and Barney (2007) argued that opportunities do not always exist objectively “out there,” but must be created by entrepreneurial action. The “effectuation approach,” building on cognitive science and associated in particular with the work of Sarasvathy (2008), sees entrepreneurs not as discovering (or creating) profit opportunities, then taking actions to exploit those opportunities, but as acting experimentally, incrementally, and with limited foresight, taking advantage of resources currently at hand – what is often described as “bricolage” (Baker & Nelson, 2005; Garud & Karnøe, 2003).

A third challenge to the opportunity-discovery view, building on Cantillon (1755), Knight (1921), Mises (1949), and Casson (1982), questions the very notion of opportunities, finding the opportunity metaphor redundant at best, misleading at worse. My recent book, *Organizing Entrepreneurial Judgment: A New Theory of the Firm* (Foss & Klein, 2012), is dedicated to reconstructing, elaborating, and extending this “judgment-based view.” In this approach, entrepreneurship is conceptualized as judgmental decision-making which takes place in a market setting under uncertainty. Entrepreneurs combine heterogeneous assets, which differ in their attributes, and deploy these assets within a firm to the production of new offerings that may satisfy customer wants at a profit. Rather than pursuing metaphorical opportunities – which are only realized ex post, after profits and losses are realized – entrepreneurs pursue profits, and try to avoid losses, by anticipating future market conditions. And they do so by establishing, organizing, and reorganizing business firms.

Entrepreneurial judgment

The judgment-based view is part of a larger stream of research seeking to make action, not opportunities, the unit of analysis for

entrepreneurship research (Holcombe, Michael Holmes, Klein, & Duane Ireland, 2014; Klein, 2008; McMullen & Shepherd, 2006). The term *judgment* comes from Knight (1921), who described judgment as decision-making under un-certainty that cannot be modeled or parameterized as a set of formal decision rules. Judgment is midway between the “rational decision-making” of neoclassical economics models and blind luck or random guessing. We sometimes call it intuition, gut feeling, or understanding. In a world of Knightian uncertainty, and heterogeneous capital resources with attributes that are subjectively perceived and unknowable ex ante, some agency must bear the responsibility of owning, controlling, deploying, and redeploying these resources in the service of consumer wants. That, in the judgment-based perspective, is the role of the entrepreneur. The entrepreneur’s job is to combine and recombine heterogeneous capital resources in pursuit of profit (and the avoidance of loss). When the entrepreneur is successful in acquiring resources at prices below their realized marginal revenue products – i.e., when the entrepreneur exercises good judgment – she earns an economic profit. When her judgments are poor, she earns an economic loss. Competition among entrepreneurs (and those who provide financial capital to entrepreneurs) tends to steer ownership and control of productive resources toward those entrepreneurs with better judgment.

Unlike other approaches to entrepreneurship, the judgment-based view closely links entrepreneurship to ownership and economic organization. Knight (1921, p. 271) argued that judgmental decision-making is inseparable from responsibility and control, that is, ownership and direction of a business venture. “The essence of enterprise is the specialization of the function of responsible direction of economic life. . . Any degree of effective exercise of judgment, or making decisions, is in a free society coupled with a corresponding degree of uncertainty-bearing, of taking the responsibility for those decisions.” Hence entrepreneurs own assets, and entrepreneurial action is manifest in firms.

Foss and Klein (2015) offer a summary of the judgment-based view and respond to some criticisms and concerns. One problem is that the theory is largely agnostic about the exact cognitive and psychological mechanisms underlying entrepreneurial judgment. For explaining firm existence, boundaries, and internal structure, a general, abstract conception of judgment may suffice. But there may be gains to a more systematic treatment of decision-making under uncertainty, following thinkers such as Shackle (Packard, Clark, & Klein, 2016) or Bayesian decision models (Bewley, 1986, 1989). Another issue is that “judgment,” as the act of making decisions under uncertainty, is often confused with the ordinary-language meaning of judgment, which connotes wisdom, discernment, or discretion. Judgment per se, as we use the term, is different from “good judgment.” Of course, given market competition, entrepreneurs who systematically make good judgments will tend to prosper at the expense of those who tend to make poor judgments, so there is a link between judgment per se and good judgment. But the potentially ambiguous nature of the term “judgment” has led to some unnecessary confusion (e.g., Foss & Klein, 2012: 95–96; Sarasvathy & Dew, 2013).

² Recent work on “strategic entrepreneurship” (Klein, Barney, & Foss, 2013) has begun to apply entrepreneurial concepts, tools, and methods to established firms, but adds little to conventional (transaction cost, agency theoretic, or property rights) explanations of firm existence, boundaries, and internal organization.

³ See Klein and Bylund (2014) for a discussion of Kirzner’s influence on the field.

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