

# Example answer to exam on entrepreneurship



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Many academic studies have tried to offer an explanation to “ why” people engage in entrepreneurial activities and “ what” factors influence individuals to decide to become entrepreneurs. The answers range from individual characteristics like genetic reasons (Nocolaou et al., 2008), the possession of balanced skills (Lazear, 2005), psychological and personality traces (Zhao and Seibert, 2006) to environmental factors like institutional settings (Aldrich and Fiol, 1994), geographic inertia created from social embeddedness (Sorensen and Sorensen, 2003) and the industry structure (Glaeser et al, 2009). Acknowledging those differences Thornton (1999) suggests that the entrepreneurship literature can be classified into two distinct schools: one called supply-side perspective and the other demand-side perspective and even though both are concerned about the same phenomena they use different approaches. According to Thornton, while the first is focused on the individual characteristics of entrepreneurs, the second is concerned with the influence of the contextual factors on the creation or restriction of entrepreneurial behaviors. A careful and impartial analysis of the arguments presented by the different theoretical trends leads to the conclusion that it is not possible to isolate a single concept able to cover all different individual and environmental dimensions described in the entrepreneurship literature. In doing so researchers have behaved like the proverbial blind men trying to describe an elephant, with some concepts treating entrepreneurs like ropes, others like threes and still others like snakes (Carland and Carland, 2004). Thus, in order to have a full picture, or at least a better one, of the entrepreneurship phenomena it is advisable the use of more than one analytical level (e. g., individual and environmental). For example, while the founding of a firm may be understood as an act heavily dependent on the

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individual entrepreneur, as would be suggested by a supply-side approach, it is also very clear that a single individual is very unlikely to successfully mobilize without the necessary infrastructure, as suggested by the demand-side perspective (Thornton, 1999). This way, even though the isolation of specific factors can offer an efficient alternative to advance the entrepreneurship literature, it is important to keep open the possibility for the use of integrative frameworks.

Venkataraman (1997) points out that the main concerns observed in the entrepreneurship literature has been clustered on three points: (1) “ How” and “ why” opportunities for the creation of goods and services arise in an economy (entrepreneurial opportunities); (2) “ How” and “ Why” some individuals are able to discover and exploit these opportunities while others cannot or do not, and, (3) what are the economic and social outcomes of an entrepreneurial act (for both the society and the individual entrepreneur). Trying to follow an integrative approach some authors (e. g., Venkataraman, 1997; Shane, 2000; Chiles et al., 2007) suggest that the Austrian Tradition offers a comprehensive view that fits well with the different dimensions that encompass the entrepreneurship phenomenon. Notably two of the strongest contributions emerging from that theoretical school are Schumpeter and Kirzner (Chiles et al., 2007). Following the ideas of those theorists organizational scholars developed two different, but deeply correlated perspectives. The first is based on the Schumpeterian tradition and sees entrepreneurs as innovative and creative individuals that disrupt the economic order through a process that Schumpeter describes as “ creative destruction”. And the second, following Kirzner, considers entrepreneurs as

individuals who discover opportunities emerging from incorrectness and disequilibrium conditions and exploit them by moving the market toward an equilibrium condition (even though the equilibrium is never reached).

Surprisingly, it is possible to observe a supplementary nature between those two perspectives, since the Schumpeterian entrepreneur would be the cause of disruption in the economic system that consequently will generate market failures, while the Kirznerian entrepreneur makes corrections (by acting entrepreneurially and taking advantage of market failures) and drives the economy to converge toward equilibrium again, creating suitable conditions for a new disruption (Chiles et al., 2007). The paragraphs that follow will try to discuss how those approaches can be used to consider and analyze issues regarding entrepreneurship.

Following many of the assumption found in the Austrian School, Shane (2000) starts his approach to explain “ how” and “ why” entrepreneurs exist by describing entrepreneurial opportunities as opportunities for bringing into existence goods, services, raw materials and organizing methods that allow outputs to be sold by a price superior to their production costs. Moreover, according to him, the existence of market failures and information asymmetry are some of the two main determinants for the existence of entrepreneurial opportunities in an economy. The presence of market failures implies that resources are being misallocated and not put into their best use (Casson, 1982) and therefore there are possibilities for reorganization or creation of new ways for their use (an entrepreneurial act) (Cantner et al., 2007). A simple example of market failure that could generate an entrepreneurial opportunity would be the case of some

unattended demands caused by a misalignment between the demand and supply for a specific good; in this case entrepreneurs would be inclined to enter this market and expand the offer (of the good in question) by means of satisfying the consumer's needs and use the opportunity to generate and appropriate profit. Regarding the influence that information asymmetry has on the creation of opportunities for entrepreneurs, it is possible to infer that if all individuals had the same level of information (about market conditions and characteristics) at the same point in time (perfect information) they would be more likely to recognize the same opportunities and consequently would end up competing on price (those that decided to take advantage of that opportunity), what would reduce the incentives that individuals have to become entrepreneurs. Supporting this perspective Kaish and Gilad (1991) argue that entrepreneurs are opportunistic learners that act combining the search for information (opportunities) with the opportunistic reactions to chance events. This way, according to this perspective the presence of information asymmetry and the existence of market failures are critical determinants for the existence of entrepreneurial opportunities and therefore the very existence of entrepreneurs.

The arguments above are only concerned with contextual explanations (present in the environment) while individual reasons were not discussed, which at the very best produces an incomplete approach. In order to have a more comprehensive perspective Shane (2000) also concentrated his arguments on the fact that individuals are not equally likely to discover the same entrepreneurial opportunities. He tried to explain why individuals become entrepreneurs by suggesting that the possession of idiosyncratic

information allows people to see particular opportunities that others cannot see. Considering that individuals have different stocks of knowledge formed from professional experiences, academic background, socio-economic context and situations that people pass over their lives, each individual is expected to be more likely to find certain opportunities and unlikely to find others. An important moderator present in the relationship between the discovery of opportunities and the possession of idiosyncratic knowledge is the very nature of the knowledge accumulated by an individual, since a person is more likely to find an opportunity to become an entrepreneur in areas related to the ones he already possess knowledge about. For example, an individual with an academic degree and professional experience in engineering will be more likely to identify an opportunity (originated from a market failure) to offer a product or service in areas related with building and construction instead of entertainment. Supporting this perspective, Cohen and Levinthal (1990) claim that in order to enter a new market it is necessary to overcome knowledge-based barriers since to access those markets it is first necessary to recognize and interpret new external information. Consequently, prior knowledge represents an important selection mechanism for what individuals will be able to identify and take advantages of emerging opportunities. A whole picture of this perspective could be described as differences in idiosyncratic knowledge among individuals as the driver of the likelihood that one person will identify a market failure (entrepreneurial opportunity) that others are not able to; this condition will be enhanced by the existence of information asymmetry. A relevant point that emerges from the arguments above is the fact that characteristics like genetics or personality traces are not among the reasons

to explain why some individuals become entrepreneurs while others do not. In fact it seems that this theoretical trend tends to refuse or neglect the arguments that individual characteristics, other than the possession of idiosyncratic knowledge, can explain the existence of entrepreneurial acts.

On the other hand, following the Schumpeterian tradition, it is possible to observe a description of situations in which entrepreneurs do not necessarily start their activities based on a market failure. Those situations are likely to be observed when an entrepreneurial act is associated with the creation of a completely novel good, new method of production, new market, new source of supply and/or a new form of industry organization (Schumpeter, 1934, p. 66). While entrepreneurs that build their activities on a market failure are more likely to be found in ordinary and existing markets, this second type of entrepreneur is associated with completely new ideas, concepts and acts of creativity. The definition of entrepreneur proposed by Schumpeter can be easily linked to this second type of individuals described here. According to Schumpeter “. . . the function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, by reorganizing an industry and so on” (p. 132). Going deep in the description offered by Schumpeter it is possible to observe that despite the fact that the starting point for an entrepreneurial activity was not a market failure; the expected outcome of an entrepreneurial act is indissociable from the destruction of the established economic order, which acts moving the economy away from the steady state. Therefore, the

theoretical evidences support that if entrepreneurs do not originate from market failures they are very likely to lead the economic system to a situation of disequilibrium. An interesting point regarding this theoretical trend is the sharply divergences from Kirzner, since the Schumpeterian entrepreneur is described as a “heroic” figure who will create and introduce revolutionary combinations into the market (Chiles et al., 2007), considered by Schumpeter as differentiated individuals when compared to the whole society. Additionally, considering the magnitude of the impact that an entrepreneurial outcome generate in the economy, according to this perspective entrepreneurs have necessarily to be individuals rarely found, or at least the outcomes originating from an entrepreneur cannot be ordinary happenings, other way the economic system would be driven into situation of complete chaos (by the effect of a continuous process of creative destruction).

An important issue that emerges from the analyses above is the fact that even though innovations have been extensively described as the key function of entrepreneurship, empirical evidences give contradictory results. While it is very tempting to describe entrepreneurs as very creative individuals able to revolutionize the economic system, Singer (1990) argues that entrepreneurial acts can be classified in a continuum that ranges from completely new and innovative to the replication of existing products, services and process. In fact, most of the innovations inserted into the market are heavily based (if not all innovations) on ideas and items already invented, and despite of the lack of originality those products and services can be considered the vast majority of what is brought into the market by



entrepreneurs. Shane (2008) gives a good picture of this fact by describing what he calls the “the myth of entrepreneurship”. Shane gives four important evidences: 1- Individuals who change jobs more often or who are unemployed are more likely to open their own business, configuring what Block and Sandner (2009) describe as necessity entrepreneurs, characteristic that does not match with the “heroic” individual; 2- Around 35 to 40 percent of all business started in US each year are concentrated on construction, retail and professional services, which historically are characterized by the low rate of creation of new products, services or organizational forms; 3- Individuals are more likely to start their own companies in poorer and agricultural places than in richer and more industrialized places, which interestingly suggest that entrepreneurs are more likely to emerge in environments with more scarce resources (This is not the case for some specific sectors like software or biotech, but in more traditional and ordinary ones that seems to be); and finally 4- Considering the percentage of the working-age population it was possible to observe that, in 2002, around 30% of the Turkish individuals, 18% of Spaniards, 10% of Germanys, 8% of Danish and 7% of Americans were self-employed, and the results are even more interesting in pointing out that as much as 40% of the US population will be self-employed at some point of their life. Additionally, it is also possible to observe that each year in the US more people starting their own business than getting married or have children (Shane, 2008, p. 3). Those evidences indicate that entrepreneurs are not very rare individuals with special characteristics, but are very present in the day to day activities of the economy.

Although the empirical evidences described above seem to give support to the arguments proposed by authors like Venkataraman (1997), Shane (2000), Chiles et al., (2007) and Cantner et al., al (2007) the attempt to explain why some individuals become entrepreneurs solely based on market failures, information asymmetry and prior knowledge presents some limitations. The most notably one is the lack of efforts to incorporate alternative explanations that are not necessarily competing ones, but complementary. For example, the argument that the individuals with prior and related knowledge are the most likely ones to exploit entrepreneurial opportunities is not necessarily contradicted by the existence of genetic predispositions, balanced skills or psychological traces. While the possession of prior knowledge gives an individual great part of the necessary conditions to take advantage or not of an opportunity, it is necessary to explain “ why” some individuals decide to take advantage of it and “ why” others decide not to do that. In the end the ultimate analytical question relies on the decision, since an individual can always choose not to become an entrepreneur even possessing all the necessary conditions. Moreover, the assumption that a person will always exploit any entrepreneurial opportunity that he/she can identify is highly unrealistic. Additionally, a similar logic can also be applied to the environmental and contextual factors that influence the emergence of entrepreneurs, since the explanations presented here do not provide a more comprehensive description for what industry, institutional or regional settings and conditions can favor or hinge the emergence entrepreneurial opportunities. This way, trying to offer a more realistic framework, the analyses that follow will adopt part of the Austrian tradition assumptions as a baseline to build on and integrate it with complementary explanations.