

The Entrepreneur in Microeconomic Theory

Disappearance and Explanation

Humberto Barreto

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Publisher's Note

The publisher has gone to great lengths to ensure the quality
of this reprint but points out that some imperfections in the
original may be apparent

To my best friend, Tami,
and my daughter, Tyler

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Preface

I have found it quite difficult to put ‘finishing touches’ on this book and send it in for final publication. I know there are many other changes that could be made to improve the exposition and style, but I also know that this process would go on indefinitely if my goal were to write the perfect book. Thus, in a thinly veiled attempt to head off criticism, I offer the following excuses.

To the reader who thinks certain sections are too simplistic, I ask for your patience. The exposition must allow the non-expert access to modern microeconomic theory if the argument is to have any hope of being understood. I have assumed a basic working knowledge of the theory of the firm (including its constituent isoquant, output, and factor market optimization problems), but have tried to explain carefully how the pieces of the theory fit together.

To the reader who thinks certain sections are too technical or mathematical, I suggest you examine an intermediate microtheory textbook and graduate level microtheory text. Once again, it is important that the modern theory of the firm and the orthodox theory of value be well understood – especially the interrelations between various facets of the overall theory.

To the reader who thinks a full-scale diatribe against orthodox microeconomic theory is in order, I am sorry to disappoint you. Modern microtheory does many things well, not the least of which is to present a logically tight, internally consistent theoretical structure. Anyone who disagrees with this is bucking over a half-century of economic thought. The point of this book is not that microtheory cannot do anything right, but that its beneficial points come at a cost – the loss of the entrepreneur. This leaves the orthodox economist without an historically key player in the explanation of the market system. And thus economics must swing back and rediscover the entrepreneur, especially as technological change becomes increasingly important.

Preface

It is quite unfair, however, to say that the wrong decision was made in the 1930s or to replay Jevons' charge against Ricardo and argue that Hicks Samuelson *et al.* 'shunted the car of economic science on the wrong track'. At the time, the development of the theory of the firm was a significant accomplishment – the culmination of years of hard work – and had confused Leon Walras the man Schumpeter credits as the greatest pure theorist of all time. But time passes and economic theory must advance. It is here that the heretic will agree with my charge that the very property, consistency, which made the theory initially appealing is now preventing orthodox microeconomics from considering radically different approaches. This is a situation that can be remedied only by the emergence of completely different, totally incommensurable research programs. Obviously, time will tell.

Of course, all errors and omissions are my own, but I would like to thank those people who supported my efforts. Professor Vincent J. Tarascio spent many hours discussing the ideas contained herein and provided useful comments. Professor Israel Kirzner kindly agreed to read the manuscript and encouraged me to publish it. Scott Hemmerlein helped proof the manuscript and construct the tables and graphs. Finally, I wish to thank my friends at the University of North Carolina and Wabash College for listening to me bemoan the disappearance of the entrepreneur and complain about the failures of orthodox economics.

Introduction

The entrepreneur has played a wide variety of functional roles throughout the history of economic thought. From Richard Cantillon, writing before Adam Smith, to the present-day Austrian economics revival, the entrepreneur has been cast as a fundamental agent in production, distribution, and growth theories. The entrepreneur has been a coordinator, arbitrageur, innovator, and uncertainty-bearer in theories spanning place, time, and problem orientation.

Since the 1930s, however, orthodox microeconomic theory has removed entrepreneurial considerations from its explanatory structure; the entrepreneur ‘virtually disappeared from the theoretical literature’.¹ The word ‘entrepreneur’ may still occasionally be used, but it has lost any real meaning. Entrepreneurship, in any of its various facets, does not play a vital role in modern microtheory. This is all the more paradoxical since the theory attempts to describe the allocation of resources under a market system – a problem in which the entrepreneur traditionally played a major role.

The question which this study seeks to answer is straightforward: why did the entrepreneur, a fundamental element throughout the history of economic thought, disappear from modern orthodox microeconomics? Of course, in answering this question, a series of related issues must be analyzed, including: (a) a review of the leading roles the entrepreneur is claimed to have played; (b) a determination of exactly when and how the entrepreneur disappeared; and (c) a judgment as to the efficacy of such a change.

Furthermore, the answer to the question is complicated because, as phrased, the query permits several levels of correct responses, each level corresponding to a different meaning of the word ‘why’. In an attempt to thoroughly answer the question, a three-level answer will be presented.

The entrepreneur in microeconomic theory

The first level will describe how the entrepreneur actually disappeared. A review of the histories of entrepreneurial and microeconomic thought is presented in an attempt to give an 'eyewitness account' of the disappearance. The goal is to show that the rapid intellectual changes occurring in the 1930s in microeconomic theory coincided exactly with the disappearance of the entrepreneur from microtheory.

The second level of explanation will focus on the actual reasons for the demise of the entrepreneur. By closely examining modern microeconomic theory (including the theory of the firm), it will be shown that the entrepreneur (in any of the traditional roles) simply cannot exist within the framework of orthodox economic theory.

Finally, and most importantly, the third level of explanation will concentrate on the motivating element behind the elimination of the entrepreneur from current microeconomic theory. The key to this deepest level of explanation lies in consistency – an indispensable attribute of any theoretical structure. Orthodox microeconomic theory is the ultimate fulfilment, in economics, of a perfectly interlocking, self-contained model. The theory of production is composed of three mutually consistent characterizations of the firm's optimization problem: the isoquant, output, and factor market sides. Distribution theory directly results from the solution of the factor-market side maximization problem. Furthermore, in conjunction with consumer theory, the orthodox theory of value is formed. Thus modern orthodox microeconomic theory is a set of internally consistent, nested models, a series of pieces that fit perfectly together to form a grand, unified whole.

Any attempt to introduce the entrepreneur into this theoretical structure destroys the internal consistency of the model. The fundamental explanation for the disappearance of the entrepreneur from microtheory lies in the inability to compromise the consistency requirement. The choice is an 'either-or' proposition; there is no marginal adjustment, no happy medium. The corner solution which modern microtheory has chosen is consistency, and for this reason the entrepreneur has been removed from the orthodox explanatory scheme.

Finally, the reader should note that the explanation advanced here does not have a motivating element behind it – more specifically, there is no particular axe to grind. The purpose of this study is to provide a detailed examination of entrepreneurship and its role throughout the history of microeconomics. Although judgment is passed on the net effects of the elimination of the entrepreneur from orthodox economics, this book is not an addition

to the rapidly growing ‘what’s wrong with economics’ library. Instead, it attempts a thorough explanation for an interesting problem in the history of economic thought.

The organization of this book is quite straightforward. The next chapter will review the various roles played by the entrepreneur in the history of economic thought. A framework is presented from which entrepreneurial theories can be categorized and compared. Chapter 3 focuses on the role of the entrepreneur throughout the history of microeconomic theory. The goal here is to show that the entrepreneur did in fact play a major role in mainstream economic theory and did in fact disappear from the orthodox theory.

Thus Chapters 2 and 3 lay the foundation for our question: why did the entrepreneur disappear? The remainder of the book is dedicated to presenting an answer to this question. Chapter 4 contains the first level of explanation – a description of what actually happened. The second level, a more detailed analysis of why the entrepreneur and modern microeconomics could not co-exist, is found in Chapter 5. Finally, the motivation behind the disappearance, the third and most important level of explanation, is discussed in Chapter 6. Judgment of the desirability of the chosen path and some thoughts on the future of microeconomics are reserved for the final chapter.

Note

- 1 William J. Baumol, ‘Entrepreneurship in economic theory’, *American Economic Review* 58 (May 1968): 64.

Chapter one

The entrepreneur throughout the history of economic thought

Introduction

For the entrepreneur to disappear from economic theory, he must have been visible at some point in time. In fact, the entrepreneur was more than merely present; he played several fundamental roles in a wide variety of settings. The entrepreneur has been risk-bearer, innovator, industrial leader – the list is almost endless. Entrepreneurship has been used as an explanatory factor in theories designed to analyze growth (and technological change), uncertainty, firm decision-making (and ownership), and the properties of the market system.

It is this extensive and constantly crucial use of the entrepreneur that makes the question of his disappearance from a particular school of economics interesting. This chapter will show just how wide-ranging and how fundamental the entrepreneur has been throughout the history of economic thought.

In order to analyze this main point, a categorization of the many facets of entrepreneurship must be devised. Thus a derivative benefit from the effort to show the important roles the entrepreneur has played is the development of a taxonomy of entrepreneurship. Arranging a mix of different characterizations into a logical framework provides a method with which to analyze research into entrepreneurship. The ultimate objective, however, is to convey the fundamental, indispensable nature of the entrepreneur throughout the history of economic thought.

The key to analyzing the intellectual history of entrepreneurship lies in the framework chosen to present the myriad of characterizations. There are three choices available: categorization by individual author, school, or functional role.

The first two are the traditional means of organization in the history of economic thought.¹ The analysis focuses on the determination of a particular individual's or school's understanding of a

given problem. The goal is often a comparison of different points of view, a description of the development of the given problem, or recognition of specific achievements.

None of these, however, is the present objective. There will be no chronological development of the theory of the entrepreneur, primarily because there is no generally accepted theory of entrepreneurship. There is no 'right' answer – only many different ways of viewing the problem. Thus our taxonomy must be determined by the entrepreneur's functional role. This approach will highlight the many varied roles the entrepreneur has played throughout the history of economic thought and avoid issues of priority or correctness.

The entrepreneurial classification scheme presented in this chapter contains four main entries: coordination, arbitrage, innovation, and uncertainty-bearing. In addition, the last category contains three subgroupings: speculation, ownership, and decision-making.

The work of every theorist who has subscribed to a particular view of entrepreneurship will not be reviewed. Instead, a representative work will be chosen and examined. Thus the entrepreneur as coordinator focuses on Jean-Baptiste Say's entrepreneur as combiner of resources. Israel Kirzner's work represents the Austrian theory of the entrepreneur as arbitrageur, an equilibrating agent in a world of imperfect information. The entrepreneur as innovator is captured in Joseph Schumpeter's theory of economic development. Finally, the entrepreneur as uncertainty-bearer is analyzed. The tripartite division is composed of the following representatives: Richard Cantillon (entrepreneur as speculator), F. B. Hawley (entrepreneur as owner of the output), and Frank Knight (entrepreneur as ultimate decision-maker under uncertainty).

It is important to note that neither priority nor any special dominance is bestowed upon those singled out for review. The choices were made based on the clarity of exposition and the specific focus on a particular functional role. For theories in which the entrepreneur plays more than one role, the particular function under consideration will be highlighted.

In addition, the various roles will not be compared or judged. The reader will notice that some descriptions of the entrepreneur's part in the market system are directly contradictory. Although it would be interesting and worthwhile to try to fit the pieces together, this task is outside the scope of this work. Once again, the crucial point to be conveyed is an appreciation for the various dominant roles the entrepreneur has played in the history of