THEORETICAL ASPECTS OF ENTREPRENEURSHIP

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Structure of presentation

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- An overview of the empirical studies on the relationship between entrepreneurship & business cycles
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  - A-cyclicality
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Historical development of the phenomenon of entrepreneurship

Historical development of the phenomenon of entrepreneurship (1)

Early Theories of Entrepreneurship

Richard Cantillon (1680-1734)

R. Cantillon (1732, Essay on the Nature of Commerce in General) was the first of the major economic thinkers to define the entrepreneur as an agent who buys means of production at certain prices to combine them into a new product. He identified the willingness to bear the personal financial risk of a business venture as the defining characteristic of an entrepreneur.

In the early 1800s, Jean Baptise Say (1767-1832) improved Cantillion's definition by adding that the entrepreneur brings people together to build a productive item. Say stressed the role of the entrepreneur in creating value by moving resources out of less productive areas and into more productive ones.

John Stuart Mill (1806-1873) (1848, Principals of Political Economy) used the term "entrepreneur" to refer to a person who assumes both the risk and the management of a business.

Historical development of the phenomenon of entrepreneurship (2)

Frank Knight and the Uncertainty Concept

Frank Knight (1885-1972) first introduced the dimension of risk-taking as a central characteristic of entrepreneurship. He adopted the theory of early economists such as Richard Cantillon and J B Say, and added the dimension of risk-taking. This theory considers uncertainty as a factor of production, and holds the main function of the entrepreneur as acting in anticipation of future events. The entrepreneur earns profit as a reward for taking such risks.

Historical development of the phenomenon of entrepreneurship (3)

Joseph Schumpeter and the Creative Destruction

Joseph Schumpeter's (1883-1950) innovation theory of entrepreneurship (1949); stressed the role of the entrepreneur as an innovator. Entrepreneurship takes place when the entrepreneur creates a new product, introduces a new way of making a product, discovers a new market, finds a new source of raw material.

Disequilibrium role of entrepreneur. Disruptive force as the source of true economic progress.

Schumpeter's innovation theory however ignores the entrepreneur's risk taking ability and organizational skills, and place undue importance on innovation. This theory applies to large-scale businesses, but economic conditions force small entrepreneurs to imitate rather than innovate.

Other economists have added a dimension to imitating and adapting to innovation. This entails successful imitation by adapting a product to a niche in a better way than the original product.

Historical development of the phenomenon of entrepreneurship (4)

Israel Kirzner and the Austrian School

Israel Kirzner (1930-) views entrepreneurship as an equilibrating force in which entrepreneurs discover previously unnoticed profit opportunities and act on them, bringing markets toward their zero economic profit, long-run equilibria.

Spontaneous learning and alertness - two major characteristics of entrepreneurship. Entrepreneurship as is the transformation of spontaneous learning to conscious knowledge, motivated by the prospects of some gain.

Kirzner's 'arbitraging' entrepreneur initiates a change that moves a market toward equilibrium, rather than disrupting an existing equilibrium as it does Schumpeter's entrepreneur.

Historical development of the phenomenon of entrepreneurship (5)

William Baumol and the role of incentives

Baumol's (1990, Entrepreneurship: productive, unproductive and destructive) theory of productive and unproductive entrepreneurship)

He hypothesizes that entrepreneurial individuals channel their effort in different directions depending on the quality of prevailing economic, political, and legal institutions. This institutional structure determines the relative reward to investing entrepreneurial energies into productive market activities versus unproductive political and legal activities (e.g., lobbying and lawsuits). Good institutions channel effort into productive entrepreneurship, sustaining higher rates of economic growth.

An overview of the empirical studies on the relationship between entrepreneurship & business cycles

An overview of the empirical studies on the relationship between entrepreneurship & business cycles (1)

Pro-cyclicality

Shleifer 1986 *Theoretical quantitative model*	Pro-cyclicality of entrepreneurship emerging as an effect of entrepreneurs` decision not to internalize external effects of their decisions to innovate and invest.
Audretsch, Acs 1994 *Pooled cross-section regression model*	New firm startups are positively correlated with economic growth, pursuing of innovative activities and university-based research
Rampini 2004 *Theoretical model of the optimal contracting*	Entrepreneurial activity is pro-cyclical due to the risk associated with it.
Klapper at . 2014 *Pooled OLS*	Strong pro-cyclical pattern of new firm registration

An overview of the empirical studies on the relationship between entrepreneurship & business cycles (2)

Counter-cyclicality

Caballero, Hamour 1991 *The model of creative destruction.*	Productivity improving activities are undertaken during recessions when opportunity costs are temporarily low.
Francois, Lloyd-Ellis 2003 *Theoretical; quantitative model.*	Entrepreneurs do innovations and produce when costs are low (during recessions) and sale during booms when demand is high.
Blanchflower 2000 *Pooled OLS, fixed effects models, probit models*	Negative relationships between self-employment rates and unemployment rates for most OECD countries. Exceptions were Italy and Iceland.
Perotin 1996 *Poisson Maximum Likelihood (ML) estimations*	Cooperative creations tend to be more counter-cyclical than conventional firms.
Milan et al. 2014 *Random effects binary logit models*	Own-account workers are less likely to hire employees during recessions.

An overview of the empirical studies on the relationship between entrepreneurship & business cycles (3)

Neither pro-cyclicality nor counter-cyclicality

Bernanke, Gertler 1993 *Theoretical neoclassical model of real business cycle.*	Agency costs of investing are inversely related to entrepreneurs` net worth; emergence of accelerator effect during expansion phase of business cycle; asymmetric shocks on productivity
Carlstrom, Fuerst 1997 *General equilibrium model.*	Assumption that share of entrepreneurs in population is constant and does not fluctuate along business cycle.

Pre-cyclicality (Leading indicator)

Koellinger, Thurik 2009 *Bivariate correlation, regression analysis.*	Entrepreneurship is a leading indicator of business cycles.

Thank you