

An Entrepreneurial Theory of the Firm

Frédéric E. Sautet



Foundations of the Market Economy

AN ENTREPRENEURIAL THEORY OF THE FIRM

Frédéric E. Sautet
with a foreword by Israel M. Kirzner



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AN ENTREPRENEURIAL THEORY OF THE FIRM

Traditional theories of the firm have concentrated on such topics as technology, evolution, transaction costs and property rights whilst failing to account for one of the most fundamental aspects of the market process: entrepreneurial activity. Using an approach consistent with the modern Austrian School, Frédéric Sautet brings a fresh perspective to the economics of the firm by developing the open-ended theories initiated by Mises and Hayek.

An Entrepreneurial Theory of the Firm makes a thorough and comprehensive enquiry into the nature of the relationship that exists between firms and markets, with separate, in-depth explorations of both the existence and inner organization of the firm. Sautet develops a model that explains the emergence of the firm in the market process as the result of entrepreneurial activity in the context of genuine uncertainty and rivalrous competition. The Austrian angle enables him to provide a theory that is both alternative and complementary to established viewpoints.

This original, provocative work offers a thorough and convincing theory that encompasses a wealth of existing literature and leads it in an entirely new direction. It will inspire and be of great interest to economic scholars, particular within the fields of Austrian economics and theory of the firm.

An Entrepreneurial Theory of the Firm includes a foreword by Israel M. Kirzner.

Frédéric Sautet works for the New Zealand Treasury.

FOUNDATIONS OF THE MARKET ECONOMY

Edited by Mario J. Rizzo

New York University

and

Lawrence H. White

University of Georgia

A central theme of this series is the importance of understanding and assessing the market economy from a perspective broader than the static economics of perfect competition and Pareto optimality. Such a perspective sees markets as causal processes generated by the preferences, expectations and beliefs of economic agents. The creative acts of entrepreneurship that uncover new information about preferences, prices, and technology are central to these processes with respect to their ability to promote the discovery and use of knowledge in society.

The market economy consists of a set of institutions that facilitate voluntary cooperation and exchange among individuals. These institutions include the legal and ethical framework as well as more narrowly “economic” patterns of social interaction. Thus the law, legal institutions, and cultural or ethical norms, as well as ordinary business practices and monetary phenomena, fall within the analytical domain of the economist.

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À la mémoire de mon père Jean-Paul et de mes grands-pères
Camille et Eugène, et pour l'amour de ma grand-mère
Eugénie, de ma mère Maryse et de ma sœur Caroline.

FOREWORD

Dr Frédéric Sautet's book offers the economics profession an outstanding contribution in two distinct respects. It presents, first of all, a satisfyingly rich theory of the firm, going beyond the existing literature in a fresh and original direction. Secondly, Dr Sautet's study provides us with an example *par excellence* of the way in which the insights developed in modern Austrian economics can be illuminatingly applied to new areas of inquiry. We have every reason to hope and expect that this impressive work will stimulate further progress along each of these two dimensions.

Building on foundations laid down in the mid-twentieth century by Mises and by Hayek, modern Austrian economics has, in recent decades, succeeded in introducing the profession to an understanding of economic processes in the framework of *open-endedness*. The dominant approach to microeconomics sees markets as the arena within which individual decisions interact against the background of iron-clad given limits to the possible, represented by *already*-recognized opportunities (the circumstance that these opportunities have, at the outset of analysis, already been recognized, is not itself modified by the concession that what is known is qualified by the element of risk). The "open-ended" environment, on the other hand, to which the Austrians have drawn attention, is one in which relevant opportunities may exist without their having, at the outset of analysis, already been recognized; there are *no* known limits to the possible. An economics that seeks to grapple with the real-world circumstance of open-endedness must transcend an analytical framework that cannot accommodate genuine surprise. Austrian economics has sought to accomplish this goal by focusing attention on the nature and function of pure entrepreneurial discovery. It has, paradoxically enough, turned out to be the case that significant features of real-world markets, in particular the *orderliness* of markets, have become

FOREWORD

understandable precisely by the introduction of this creative, unpredictable, entrepreneurial element – the very element which, from a mainstream perspective, appears to pose *a threat* to theoretical orderliness, let alone determinacy.

Dr Sautet has skilfully deployed his deep understanding of and appreciation for the open-endedness of the entrepreneur-inspired market process, to create a fresh perspective on the emergence and the operation of the firm. Carefully and critically sifting through the large modern literature on the theory of the firm, he has judiciously identified what in that literature can, and what cannot, be incorporated into an open-ended perspective on the world. By pursuing this perspective with tenacity and insight, Dr Sautet has been able convincingly to explain features of the modern economy of firms, which can only with difficulty, if at all, be accounted for by existing approaches to the theory of the firm. He is thoroughly appreciative of the contributions of those approaches (since they offer valuable insights, the relevance of which is not lost in the open-ended environment). But, his own new perspective on the firm is able not only to retain those insights, it is able significantly to extend our economic understanding in illuminatingly new ways. In this research he has joined a group of gifted scholars who have already published valuable work on the theory of the firm, work that draws on related Austrian insights. The comprehensiveness and thoroughness of Sautet's contribution being published here, establishes him as one of the foremost researchers in this field.

Both scholars in the area of the theory of the firm and scholars in Austrian economics will be able to derive important benefit from the rich intellectual fare with which Dr Sautet presents us here. The proof validating this assertion will, I am confident, be provided by the new research which, in the years ahead, will be inspired by Dr Sautet's splendid book.

Israel M. Kirzner
June 1999

ACKNOWLEDGMENTS

Ever since I came across Ronald Coase's famous article *The Nature of the Firm* during my years as an undergraduate student at the Université de Paris Dauphine, I have been deeply interested in what economists call the theory of the firm (or how economics accounts for the existence of business organizations and their internal structures), especially in the way Ronald Coase and his followers understand the subject. This interest survived my years of undergraduate school and I eventually decided to write my doctoral dissertation on this subject. This book was born out of my doctoral dissertation.

I owe an immense intellectual debt to Professor Pascal Salin who introduced me to what I would call "sound economic science" while I was studying monetary economics under his auspices. Professor Salin is one of the great figures of economics I have had the honor of knowing during my life as a student – he exercised a decisive influence on my choice to become an economist. I am forever grateful to Professor Salin, who became my mentor during my formative years, for his profound influence on my thinking. Professor Salin's intellectual legacy underlies the present work.

Exploring the theory of the firm from an Austrian approach was a rare opportunity that was given to me by Professor Mario Rizzo. In 1995, he agreed to supervise my work during my stay at New York University as a visiting doctoral student (and subsequently as a post-doctoral researcher) in the Austrian Economics Program. I owe Professor Rizzo an immense debt of gratitude for his influence on my understanding of economics and classical liberalism and for his effort (as a co-editor of the *Foundations of the Market Economy* series) to help me turn my doctoral dissertation into a book. I can say that without Professor Rizzo's help, this book would not have existed.

ACKNOWLEDGMENTS

During three and a half years at New York University, I have had the privilege and the invaluable opportunity to work under the auspices of Professor Israel Kirzner. Toward Professor Kirzner, who was extremely attentive in commenting upon each draft of the dissertation manuscript and whose work influenced the present book enormously, I feel eternally indebted. Professor Kirzner's work on the entrepreneurial understanding of competition is one of the most important developments in economics in the last few decades. By developing Mises's and Hayek's theories of the market process, Professor Kirzner gave economists an invaluable set of tools for understanding the nature of competition. I would also like to thank Professor Kirzner from the bottom of my heart for accepting to write a generous foreword to the present book, I feel deeply honored.

While at New York University, I also had the unique chance to work under the guidance of Professor Peter Boettke (now Professor at George Mason University). To Professor Boettke, who read and commented on every draft of the dissertation manuscript and from whom I learnt the "Boettkean" way of understanding economics, I owe an immense intellectual debt.

I presented drafts of the three chapters of the dissertation manuscript to the Austrian Economics Colloquium at New York University. I would like to express my gratitude to the participants of the Colloquium for their very constructive comments. In particular I would like to thank the Austrian faculty and senior research scientists of New York University, Professor Israel Kirzner, Professor Mario Rizzo, Professor Peter Boettke and Dr David Harper. I would also like to thank the Faculty Research Fellows of the New York University Austrian Economics Program, William Buto (Trinity College), Young Back Choi (St John University), Sandford Ikeda (The State University of New York), Roger Koppl (Farleigh Dickinson University) and Joseph Salerno (Pace University), as well as the graduate students I studied with at New York University: Yisok Kim, Gilberto Salgado and Glen Whitman. I am particularly indebted to Gilberto Salgado who was my flatmate during my years at New York University and with whom I had endless discussions about economics in general and the concept of entrepreneurship in particular. I would also like to thank Father James Sadowsky (SJ) with whom I had numerous fruitful discussions on the nature of knowledge and on the content of economic science.

This book would not have become a reality without the help of the other members of my doctoral dissertation committee (in addition to

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Professors Salin, Rizzo and Boettke). First and foremost, Jacques Raiman, who helped me understand many aspects of the structure of organizations while I was working at Générale de Service Informatique (GSI, which had Jacques Raiman as CEO). GSI (now ADP) helped me finance my trip to the USA and I am forever grateful to Jacques Raiman and many other people in this company (especially Yves Stucki and Anvarali Jiva) for this opportunity. I also wish to thank Professor Nicolai Foss, from the Copenhagen Business School, for his important influence on this work, his comments on my dissertation draft and for agreeing to be a member of my doctoral dissertation committee. Last, but not least, I would like to thank Professor Daniel Pilisi, from the Université de Paris Dauphine, for agreeing to stand in my committee and for his comments on my draft dissertation.

My intellectual development, which led to the existence of this book, was also influenced by three remarkable individuals: Professor Bertrand Lemennicier (Université de Paris Assas), Henri Lepage (Institut Euro 92) and Professor Philippe Nataf (Université de Paris Dauphine). It is thanks to Henri Lepage's work and teaching at the Université de Paris Dauphine that I discovered the work of Ronald Coase. I am grateful to the three of them for their influence on my career.

My dear friends Véronique de Rugy, Philippe Chamy and Philippe Lacoude have been (and still are) irreplaceable intellectual companions and their influence on this work is beyond words. I wish to thank them for their friendship and their beneficial influence on my work.

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In addition to the economists named above, my intellectual development owes primarily to Ludwig von Mises and Friedrich A. Hayek. Mises's achievements in economics are unparalleled and Hayek gave the economic profession a unique and broad understanding of the economic problem. We may stand on the shoulders of giants to try to see further than they themselves did. Thus, one of the main challenges for Austrian economists for the years to come is to develop explanations of the ways entrepreneurship is embedded into the institutional structure of the market system and how this structure influences the discovery process. I hope the present work represents a contribution to this research program and that it helps to improve the understanding of the workings of the market system. Responsibility for the errors of this book is my own.

I gratefully acknowledge permission from Kluwer Academic publishers to reproduce material first written by Richard Langlois in *Constitutional Political Economy* (1995). I would also like to thank MIT Press for the permission to reproduce material originally written by Alfred Chandler in *Strategy and Structure* (1990). Finally, I want to express my gratitude to Prentice Hall International Inc. for permission to publish material originally written by Paul Milgrom and John Roberts in *Economics, Organization and Management* (1992).

I dedicate this book to my family. To the memory of my father, Jean-Paul, who left us far too early, to my grandfathers, Camille and Eugène, who gave me strength and belief, to my grandmother, Eugénie, my mother, Maryse and my sister, Caroline, for their love unbounded.

Frédéric E. Sautet
Wellington, New Zealand
September 1999

Scientific knowledge is judgement about things that are universal and necessary, and the conclusions of demonstration, and all scientific knowledge, follow from first principles.

Aristotle (*Nicomachean Ethics*, Book iv: Chapter 6)

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