Re-Understanding Entrepreneurship

How do entrepreneurs make decisions in the real world? Why are entrepreneurs absent from mainstream economics? What functions do entrepreneurs play in the market? What type of institutional environment is needed for entrepreneurship to play a role? Neoclassical economics is a market theory that ignores entrepreneurship. This distorts our understanding of how the real market works, leading to a theory of market failure that forms the common foundation of various government interventions. The market is not only an allocative process but, more importantly, a discovery and a creative process. To understand the real market, Weiying Zhang argues that economics must shift from a price-centric to an entrepreneur-centric paradigm. Blending theory and narrative, Zhang intersects history with the present, supporting his theory with relevant case studies. He argues that once entrepreneurship in the market is correctly understood, the foundation for government intervention is undermined and the economy can sustainably flourish.

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What It Is and Why It Matters

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Contents

Figures

Preface

The entrepreneur is the key player in the market. However, entrepreneurship is totally absent from mainstream market economics. Neoclassical economics is a market theory without entrepreneurship. This misconception of the market distorts our understanding of the real market economy, leading to a theory of market failure that forms the common foundation of various government interventions. Once entrepreneurship in the market is correctly understood, so-called market failure is nothing but a failure of market theory, and the foundation of government interventions is undermined.

Neoclassical economics cannot understand entrepreneurship mainly because the rational decision making model is inconsistent with entrepreneurial decision making. Put simply, what neoclassical economics means by a "rational decision" is not what an entrepreneurial decision means in the real market. To understand the real market, economics must shift from the price-centric paradigm to the entrepreneur-centric paradigm.

This book primarily focuses on four issues: How do entrepreneurs make decisions in the real world? Why are entrepreneurs absent from mainstream economics? What do entrepreneurs do in the market? What type of institutional environment brings entrepreneurship into play the most? The four parts, including 16 chapters, of this book revolve around these four questions. The main contents of each part are as follows.

The four chapters (1–4) in the first part titled "The Nature of Knowledge and Entrepreneurship" discuss the mental model of entrepreneur decision-making. The first chapter primarily discusses entrepreneurship from the perspective of F.A. Hayek's theories of knowledge, holding that indescribable "soft knowledge" is the most critical to entrepreneurs. Without understanding the importance of soft knowledge, it is impossible to understand entrepreneurship. Chapter 2 uses three classic examples to explain what distinguishes entrepreneurial decisions from managerial/rational decisions and forms the core of the entire book. It is extremely important for our understanding of the market economy. Entrepreneurial decision-making is not scientific decision-making, it is not making a choice under given constraints, nor is it solely focused on profit. This re-understanding of entrepreneurial decisions implies that mainstream economics' externality theory, anti-monopoly theory, and corporate governance theory must all be revised. This also means industrial policy has lost its theoretical basis. Chapter 3 holds that the essence of central planning is a systematic negation of entrepreneurship. Big data (and even artificial intelligence) cannot displace entrepreneurial decision-making. The false belief that central planning is possible with big data is extremely naïve. Chapter 4 argues that envy and misunderstanding of knowledge are the two reasons for common prejudice and hostility toward entrepreneurs.

The four chapters (5–8) in the second part titled "The Entrepreneur in Market Theories" examine the reasons entrepreneurs should hold a central position in market theory. Chapter 5 points out the eight paradoxes of the neoclassical model. The neoclassical model is not a good market theory and its Market Failure Theory is wrong. The Austrian School of economics places entrepreneurs at the center of the market and has a better understanding of the market. A paradigmatic shift is needed for understanding the real market. Chapter 6 discusses the six standards of a good market theory. A good market theory should be a theory about how the economy develops and changes, not only a theory about how the market reaches equilibrium and stability. A market theory that lacks entrepreneurs and ignores the reputation mechanism is not a good theory. Chapter 7 discusses mainstream economics' misunderstanding of monopoly and competition. Mainstream economics' concepts of competition and monopoly are incorrect. Ignoring entrepreneurship is the primary reason for this misunderstanding. Entrepreneurship and competition are two sides of the same coin. Entrepreneurship is the best anti-monopoly law because it is more conductive to the breakdown of monopolies than any legal and regulatory provisions or policies. Chapter 8 discusses the relationship between entrepreneurial profit and income distribution. A misunderstanding of profit is largely responsible for the common misunderstanding of income distribution in the market economy. I argue that entrepreneurial profit is a responsibility system which makes possible trust between strangers in the market and value creation. With entrepreneurial profit, the market economy generates common prosperity and ordinary people are the biggest beneficiaries of the market economy. Competitiveness and entrepreneurship also imply a high mobility of income distribution, rather than deepening the gap between the rich and poor.

The four chapters (9–12) in the third part titled "The Uncertainty of Innovation and Industrial Policy" examines the entrepreneurial function in economic growth and its implications on industrial policy, from the viewpoint of innovation uncertainty. Chapter 9 first reviews the traditional theories (neoclassical growth theory and Keynesian economics) that economists use to explain economic growth. Their common shortcoming is ignoring the role of entrepreneurs. The chapter then outlines the entrepreneur-centric "Smith–Schumpeterian growth model" and the two functions of entrepreneurs (i.e. arbitrage and innovation), and finally uses this framework to analyze China's economic growth over the last few decades. Chapter 10 discusses the difference between arbitrage and innovation, the unpredictability of innovation, and the four uncertainties of innovation (referring to uncertainty of technological feasibility, uncertainty of commercial value, uncertainty of related technology, and uncertainty brought about by politics, culture, and policy). The uncertainty of innovation means there cannot be a unified and centralized plan for innovation. Instead, innovation relies on the special skills and expertise of various entrepreneurs, similar to the Eight Immortals in Chinese mythology. Chapter 11 further exemplifies the uncertainty and unpredictability of innovation through a detailed case study of the competitive process between airships and airplanes in the early stage of the aviation industry. This is the most detailed and complete case study in the book and is extremely illuminating for understanding entrepreneurship and innovation. Chapter 12 first clarifies the definition of industrial policy, then analyzes the challenges faced by industrial policy from the perspective of innovation uncertainty and the incentive mechanism. Overlooking entrepreneurship is the fatal weakness of industrial policy advocates. The basic conclusion of this chapter is that industrial policy is destined to fail.

The four chapters (13–16) in the fourth part titled "Institutional Ecology of Entrepreneurship" discuss the type of institutional ecology that is most beneficial to the emergence of entrepreneurs. Chapter 13 discusses the different allocation of entrepreneurial resources in government and in commerce and its impact on the economy and society. It also discusses the type of system that is most favorable to entrepreneurial talents choosing to engage in entrepreneurial activities. The evolutionary game methodology is then used to analyze the evolutionary equilibrium of entrepreneurial talent allocation and briefly analyzes the rise of China's grassroots entrepreneurs over the last 40 years. Chapter 14 analyzes the interdependency between entrepreneurs and capitalists, holding that the government can displace neither entrepreneurs nor capitalists. It is argued that the best corporate governance structure allows entrepreneurship to play the biggest role, as opposed to restricting professional managers. Chapter 15 discusses the relationship between the rule of law and innovation, holding that the rule of law protects rights, not interests. Protecting interests hinders innovation and entrepreneurship. This chapter compares Britain and France to show that the protection of rights is related to the rise and fall of a country. Innovation grows out of an ecosystem of free competition. Artificial prohibitions, or innovation zones, stifle it. Chapter 16 discusses the challenge for entrepreneurs brought about by value conflicts between different nations. The source of this challenge might be the government or the private sector. This chapter emphasizes the serious value conflicts that have always existed between China and the United States but obscured by the good wishes of both sides in the past. As opposing values have manifested themselves, both Chinese entrepreneurs and American entrepreneurs face bigger challenges than they did over the past 40 years.

Since I began engaging in economic research, entrepreneurs have always been the topic of my research. Appendix A of this book provides a brief outline of the course taken by my research on entrepreneurs and can be helpful for understanding the entire book.

Appendix B explains my process of understanding the Austrian School. I previously believed I was following the path cut by neoclassical economics but in fact I unconsciously deviated from this path early on. Entrepreneurship became the central topic of my research precisely for this reason. In spirit, I have been a disciple of Hayek for a long time.

This book is written for scholars, bureaucrats, and entrepreneurs. I hope my fellow colleagues in economics will read this book and reflect with me on the flaws in mainstream economics and correct misunderstandings of the market. Bureaucrats reading this book can have a little less "fatal conceit" and a little more reverence toward the market. Entrepreneurs reading this book will pursue less quick successes but more foresight. Entrepreneurs will only choose innovation if they pursue long-term interests. This book is also written for the general reader. I believe that any person who reads this book in earnest will have a new comprehension of entrepreneurship and the market economy, as well as a more rational judgment of economic policy.

This book is written in a way that blends theory and story. History intersects with the present. The theoretical views in this book are supported by relevant case studies. I avoided overly academic arguments. My goal in writing this way is to allow the reader to understand profound reason from relaxed reading.

We live in an era of rapid change. Grasping the unchanging things behind the phenomena is the best way to calmly deal with changes. I believe entrepreneurship is one of those things that creates change but itself does not change.

Weiying Zhang
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