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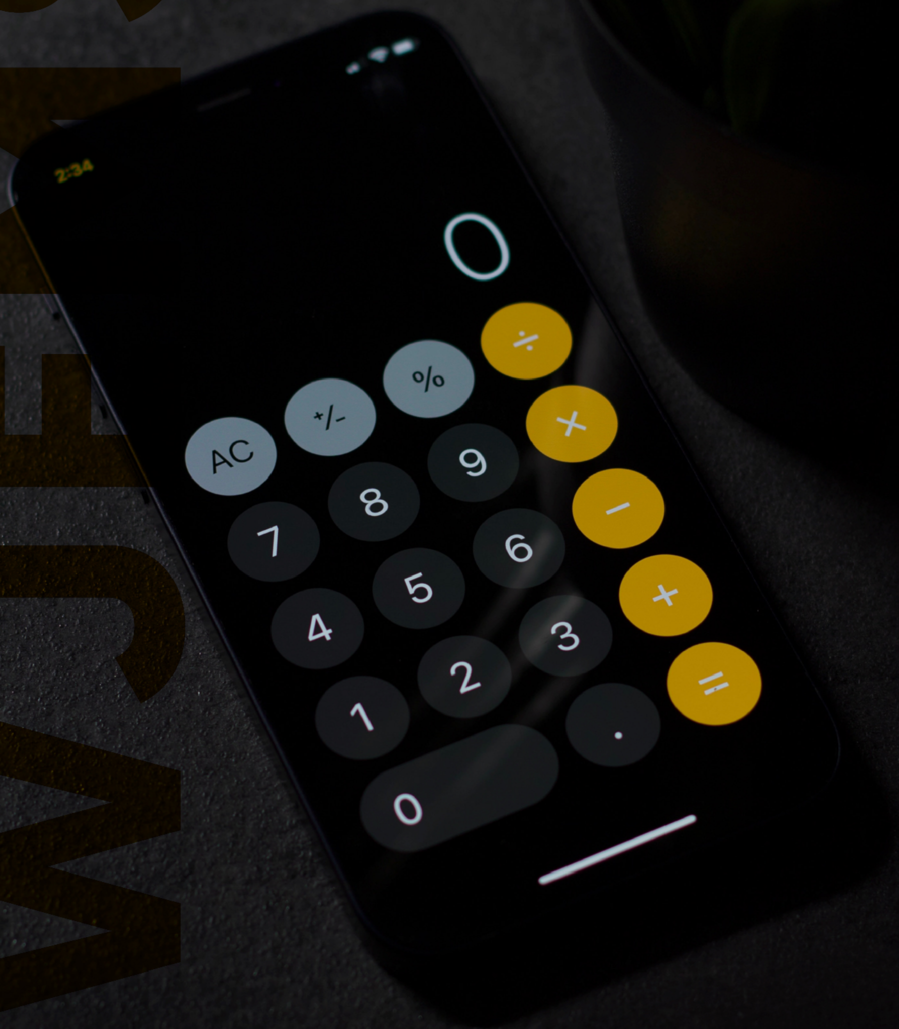
Theoretical Assumptions in Entrepreneurship and Caveats of Entrepreneurial Action



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CONCEPTUAL PAPER

Theoretical Assumptions in Entrepreneurship and Caveats of Entrepreneurial Action

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ABSTRACT

PURPOSE: The purpose of this study is to investigate the two complementary sets of assumptions in the field of entrepreneurship, i.e., the individual and the decision-making nexus in which the individual operates. The author is of the view that these two assumptions provide a concrete foundation in the development of entrepreneurship theory as the application of both approaches is apparent in widely different contexts. The complementary aspect will be studied in the context of an entrepreneurial organisation to justify the claim.

METHODOLOGY: The author has explored notable theoretical foundations in the field of entrepreneurship and tries to formulate a scenario where two diverging theoretical assumptions can work together in a complementary manner to aid the process of entrepreneurial action.

FINDINGS: This study suggests that entrepreneurs act differently in the two situations, i.e., putting together plans to support decision-making in discovery settings and constantly revising the plans to support fundamental assumptions in creation settings. This analysis does not say much about the transition time between the two situations of uncertainty and risk. It is quite possible that both conditions might hold for some time, despite being contradictory at a fundamental level.

ORIGINALITY: This study is an attempt to contextualise and differentiate between the individual and opportunity on the basis of the decision-making process by taking into consideration the elements of market uncertainty and risk. The diverging theoretical assumption of transaction cost economics and incomplete contract theory are discussed under the pretext of uncertainty transforming into risk in the market situation.

KEYWORDS: *Transaction Cost Economics; Incomplete Contract Theory; Uncertainty; Risk; Firm; Entrepreneurship*

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INTRODUCTION

The milestone of a modern theory of entrepreneurship is yet to be reached amidst the struggle that encompasses the development in the field of entrepreneurship (Ferreira *et al*., 2019). The past two decades have seen the theoretical development in the context of opportunity recognition or the individual aspect. There have been valuable contributions from the related fields of study, i.e., economics, and the revitalisation of foundational works of pioneers such as Schumpeter (Mishra and Zachary, 2015). Although the attempts made by scholars in the field of entrepreneurship are valid, the outcomes remain an ever-increasing catalogue of theoretical concepts rather than a consensus on one basic entrepreneurship theory. This can be attributed to the lack of direction and clarity in the assumption of entrepreneurship (Kenworthy and McMullan, 2018). The diverse nature of assumptions has led to explanations of entrepreneurship as promising avenues; however, the general trends remain centred around three basic themes of opportunity, individual, and decision-making. These three themes have been explored in various contexts and have ultimately led to divergent assumptions, making the explanation of the foundational concept complex and intricate (Abdallah, 2013). The critical aspect is the non-awareness of the assumptions by scholars that lead to an unclear theoretical development on the premise of reasonable or expected outcomes. The lapse in clarity regarding the assumptions is the main reason that acts as a blockade in the development of entrepreneurship theory (Klein, 2016).

The purpose of this study is to investigate the two complementary sets of assumptions in the field of entrepreneurship, i.e., the individual and the decision-making nexus in which the individual operates. The author is of the view that these two assumptions provide a concrete foundation in the development of entrepreneurship theory as the application of both approaches is apparent in widely different contexts. The complementary aspect will be studied in the context of an entrepreneurial organisation to justify the claim.

THE DISCOVERY THEORY: INDIVIDUAL/OPPORTUNITY NEXUS VIEW

The discovery theory is premised on the discovery of the opportunity as in the existence, discovery, and exploitation of those opportunities. The discovery theory complements the three assumptions in entrepreneurship: the objectivity of the opportunity, uniqueness of the individual, and their risk-bearing capability (Alvarez *et al*., 2016). The opportunities exist whether the individual is aware of their existence or not. The recognition of the opportunity by the individual lies in the situation and not the opportunity itself. These opportunities may be identified through market actions in which an entrepreneur plays a role. The capability of the entrepreneur in comprehending the dynamics of the market allows them to foresee the opportunities (Bull and Willard, 1993). A common example is the identification of opportunities of economies of scale in fragmented markets or process innovation in mature markets. This point of view states that understanding the opportunity in a market situation will yield the equal value that opportunity might yield once realised.

The second assumption is the difference among individuals that allows them to identify different opportunities or different aspects of the same opportunity. Individual alertness in entrepreneurship is a key factor that allows the identification of opportunities in the market. It has been noted in the literature that the practical aspect of entrepreneurial action is just as important as the nature of the individual that allows them to identify potential opportunities (Ripsas, 1998). The opportunities are independent of economic forces as the lack of agency might compel the exposition of an opportunity, after which the individuals can exploit it to yield profits (Frederick, *et al*., 2016).

The third assumption is the necessity of risk-bearing in the entrepreneurial process. The premise that opportunities are objective by nature adds an element of risk to the equation. The individual that can access the information with relative ease will ultimately utilise it to reap profit. Entrepreneurship is explained in the individual opportunity nexus through the relationship of two components (Angus, 2017). Every aspect in the market has its inherent opportunities inbuilt and the individuals become an agency to these opportunities through the utilisation of specific resources rather than creating new opportunities from scratch. The role of entrepreneurship is to practically exploit the opportunities through a novel combination of resources.

THE CREATION THEORY

The creation theory revolves around the entrepreneur and the firm creation. The similarity between individual opportunity nexus and firm creation theory is the presence of theoretical assumptions such as the objectivity of the opportunity, the ordinary individual, and the element of uncertainty (Alvarez and Barney, 2007). The creation theory postulates that opportunities are created in the process of exploitation of existing opportunities. It is difficult to make a differentiation between the before and after situation of an opportunity as the creation of opportunities leads to its exploitation, which in turn creates new opportunities.

Creation theory assumes that opportunities are not isolated from economic actors but are created by these economic actors (Alvarez and Barney, 2007). This allows the creation of opportunity through a process of speculation and consideration of specific aspects of the market trends (Alvarez and Barney, 2000). This process allows the individual to anticipate and exercise their knowledge of the market to create an opportunity with uncertainty; sometimes it yields an objective opportunity that correlates with an individual's hypothetical anticipations. In this way, the two differentiating aspects are the discovery and the creation of opportunities (Auerswald, 2008). One aspect discovers opportunities through knowledge of the market while the other creates new opportunities through existing opportunities. The two aspects take the role of the entrepreneur to opposite ends, where at one end entrepreneurs are independent of the opportunities and need to discover them and at the other end, entrepreneurs are those responsible for creating the opportunities (Mishra and Zachary, 2015).

Entrepreneurship is a process in which the individual does not hold a central position but the ability of the individual to take a proper decision in uncertain conditions does. The creation theory aspect does not differentiate the opportunity from the individual; rather it makes the individual a creator of the opportunity based on their decision-making during uncertain times. This means that an entrepreneur is an individual who combines the resources in a novel manner to create opportunity in the market (Chanal, 2011), without the certainty of it being a profit-generating opportunity. The differentiation instance is clear between the Individual/Opportunity (IO) nexus and the creation theory (Barney, *et al*., 2011). The decision-making aspect in creation theory is further clarified with the characteristics of the individuals. The question that arises here is whether the knowledge possessed by the individual allows them to make a decision, or whether the process of gaining knowledge and simultaneously exploiting the opportunity allows individuals to make decisions. The third assumption of creation theory is the presence of uncertainty as a necessary stipulation for entrepreneurship. The contrast with the IO nexus is the replacement of risk with uncertainty in the creation theory (Barreto, 2012).

INTERCONNECTIVITY OF ASSUMPTIONS

The explanation of entrepreneurship under creation theory shows that economic factors engage resources in uncertain scenarios. The discovery theory assumes that all the relevant information about the market forces are available but hard to access for one reason or another. The creation theory explains that the path to opportunity exploitation is uncertain and treading the path or engaging in the process changes the very nature of the opportunity that was to be exploited (Leyden and Link, 2015). That engagement in the process inherently changes the nature of the opportunity and transforms it into something unprecedented altogether as the exploration process is continued. It can be said that attempts made by the entrepreneurs to exploit the opportunity in creation theory are not aimed towards a definitive end (Blackburn and Kovalainen, 2009). The efforts could be unclear as the outcome is also uncertain. The end cannot be foreseen at the beginning. Possibilities emerge as the path of exploration is trodden and the number of possible ways keeps on increasing. The more ambiguous the outcome becomes, the more the number of probabilities becomes equally unanticipated (Ge *et al*., 2016).

ARE THESE THEORIES CONTRADICTORY OR COMPLEMENTARY?

The earlier discussion shows that the creation and discovery theories of entrepreneurship are inherently different and contradict each other. This can be attributed to the fact that the assumptions for both theories are inherently different. These can also be looked upon as complementary theories from the perspective that both are aimed at improving market conditions through exploitation of new opportunities, known or unknown (Brand, *et al*., 2019). In literature, both theoretical approaches are used to explain entrepreneurial behaviour whereas the nature of such behaviour is varied and contextual (Phelan, 2014). The argument in favour of one of these approaches is futile, instead, the approach to utilise both approaches simultaneously is better. This can be done by highlighting the positive aspects of each approach and identification of contextual factors under which these can be made applicable. In research, scholars must be clear about the approach on which they are building before venturing into the investigation of an entrepreneurial phenomenon. This can be achieved by building on the assumption of each of these theoretical approaches; this will ultimately eliminate the ambiguity in empirical conclusions.

The field of entrepreneurship is vast and encompasses the creation of new firms in the process. Most of the theories in the realm of the firm assume the objectivity of the opportunity and knowledge of the outcome beforehand (Chanal, 2011). The economic factors are identifiable and the path of opportunity exploitation is paved with bricks of risk and not uncertainty. The firm theories that will be discussed here share the assumptions of the creation and discovery theory of entrepreneurship. Popular firm theories are transaction cost and incomplete contracts theory (Garud *et al*., 2014).

CONTEMPORARY THEORIES OF THE FIRM

The transaction cost theories encompass a multitude of transactions between the parties to invest resources. Once a transaction has been carried out and an investment made, this enables that party to behave opportunistically in comparison to the parties that have not taken part in the investment. The encapsulation of such transactions within the confines of the firm allows a monitoring party to curtail opportunistic behaviour on the part of all the involved parties. Therefore, the purpose of transaction cost economics is to utilise the managerial powers in the firm to smooth out the wrinkles made by the transaction-specific investments (Covin and Slevin, 1991; Fairlie and Fossen, 2020; Fiet, 2001).

Similarly, incomplete contracts theory is also highlighted in the firm literature, describing the firm as the joint held together by contracts between various factors of production. This theory assumes that a firm is constituted when one party reserves the residual rights of control to an exchange that enables that party to make all decisions that are not otherwise allowed by law or firm custom (Lyons, 2001). The incomplete contracts theory also nominates the party eligible to hold residual rights, the part that has most to gain from that exchange. In short, the party that has most to gain from an exchange in a firm has the claim on the residual rights associated with that exchange.

Although the theoretical approaches discussed above have received attention in the literature, the empirical evidence remains more prominent for transaction cost economics in comparison with incomplete contract theory. It can be seen that the uncertainty element is a commonly perceived aspect in an entrepreneurial attempt within firms where entrepreneurs are attempting to explore and create new opportunities based on existing ones.

UNCERTAINTY AND TRANSACTION COST ECONOMICS

Among noticeable entrepreneurship scholars, it is contended that decision-making is a process that distinguishes one organisation from another. This is because decision-making is the main process that allows firms to explore and exploit opportunities in the market based on transaction-specific investments (Hallberg, 2015). For a party undertaking the decision-making process, it must be certain that the outcomes of the decision-making will yield profits that are above the expected threshold of all involved parties. This also allows the parties to ascertain that all involved are getting a fair share of the return and any opportunistic endeavours are securitised to be remedied. This means that if the management is unable to make good use of an opportunity at its discretion against the parties involved, the need for creating a firm becomes obsolete (Guercini and Cova, 2018; Ha-Brookshire, 2009). Therefore, the exercising of managerial decision-making is not compatible with opportunistic avenues and creates a problem when specific investments need to be made. This is the deduction of transaction cost theory, that uncertainty forces the parties to avoid specific investments and diminishes the formation of an organisation (Langlois, 2007).

Also, as suggested by the casual observation of transaction-specific investments under uncertainty, some firms are formed when entrepreneurs are out to exploit an opportunity about which there is not much information and data available (Hoskisson, *et al*., 2018; Kacperczyk and Marx, 2016). The question that arises here is what is that faction that is excursing the decision-making under uncertain assumptions, despite the threat of opportunism in the face of parties of exchange? As time passes and more information becomes available about the opportunities, the transformation of uncertainty into risk happens and the application of governance regarding transaction costs becomes viable.

UNCERTAINTY AND INCOMPLETE CONTRACTS

As the main assumption of the theory is the residual rights aspect, the party that seems to benefit most from the transaction is entitled to the residual rights and to make the investment for maximisation of the value. Also, the parties that seem to receive the lesser share of value must forego the residual rights in favour of the parties that seem to have the ability to maximise the exchange value (Kreiser, *et al*., 2010; Magnani and Zucchella, 2019; Mishra, 2019). This becomes clear when the outcome of the transaction yields the most value and benefits all parties involved in the exchange. The information to assign residual rights is not available beforehand in case of uncertainty. The question arises when parties are not sure who will benefit the most from an investment; in these cases, how can the residual rights be assigned and how can a firm be constituted? A common solution is to consider the firm as a framework that allows the identification of the most appropriate party to hold the residual rights. This becomes litigious when a party holding the residual rights discovers that the transformation of uncertainty into risk deems another party to be the holder of the residual rights and the party holding the residual rights refuses to withdraw (Barney, 2018). One of the main reasons is the high level of compensation that parties with residual rights are unwilling to relinquish, even in the case where, in comparison, the cost of the value of the exchange is higher than the compensation. Also, the party controlling the residual rights might not be the party in control after the opportunity has been exploited and the value of exchange received (Mohammad, *et al*., 2018). That is the reason the party with residual rights is keen on keeping the rights and shape the outcome of the exchange in their favour once the aspect of uncertainty evolves into an aspect of risk. Therefore, this theory proposes that parties are reluctant to relinquish residual rights and support the organisation of a firm as the aspect of uncertainty turning into risk remains inherent.

THE CREATION PROBLEM

In the case of transaction cost economic theory, the value to be created is taken as a given and the emphasis is put on the means to realise that value creation. However, in market uncertainty conditions the anticipated value is not known, and it must be created by the parties through careful nurturing over a passage of time (McManus, 2019). This is a process of scrutiny and successive timely investments over a period as constant monitoring is required and the parties must act according to the behaviour of the investments made to make certain modifications (Pflügler *et al*., 2016). Therefore, the ability to create value is mostly dependent upon the willingness of the parties involved to carefully monitor the stream of investments over time. This is the scenario where the creation of future value of exchange cannot be attributed to an element of surprise or luck, rather it is on a careful examination and timely modification of investments in a strategic manner. This approach maximises the potential of the investments to yield the economic value anticipated.

THE APPROPRIATION PROBLEM

It must be kept in mind that the constant monitoring and scrutiny of the investments on behalf of the parties is only possible when the parties are certain of greater economic value in exchange. The guarantee that a certain level of value can be created lies on the continuous effort on behalf of the parties; since the value creation remains uncertain, it also raises the question of appropriation of the economic value created (Kaul, 2013). Also, the appropriation of losses must be made public to the parties before their engagement in the constant monitoring of the investment process.

GOVERNANCE PROBLEMS

The problem exists even when there is no behavioural uncertainty for the parties in an exchange. If there exists a relationship between the parties that allows co-operation to a certain level thus reducing the aspect of opportunism, a contract that specifies who will take lead in the allocation of the resources in the scenario of high market uncertainty should be written (Miller and Le Breton-Miller, 2017). Under the assumption that parties to an exchange are unable to accumulate all the information regarding the outcome of an investment in writing a contract, what are the alternative ways to proceed? The way to proceed in case of uncertain conditions must be clarified in the contract for decision-making and the implementation of these decisions (Raimi, 2015; Robé, 2011).

Any such contract constitutes the organisation of a firm. This is because, by definition, the right to monitor the allocation of resources and behaviour of the parties to the exchange by a party, as long as those parties are not under obligation from other contracts or laws, constitutes a firm. In this way, the parties prefer governance that is firmly based on market-based governance as it enables the parties to maximise the value of exchange (Alvarez, 2007). As contracts with uncertain conditions can have multiple dimensions, these dimensions can form dynamic firms. In case detail on investment in a specific category of exchange is omitted, then the decision to proceed will be made accordingly. This is similar to the case when all the stipulations to proceed with an exchange are mentioned in a contract.

THE FIRM AND DECISION-MAKING

A common pattern is the high cost of negotiation between parties of equal standing and control in the firm. Even in the case of well-informed parties, the decision to proceed can encounter disagreements in cases of high market uncertainty. This happens when parties to the exchange bring forth their strategies and resources to proceed further. The party that has more to gain, as per incomplete contract theory, must assume the role of decision-making to cut costs. The party that has the most to gain from an exchange will certainly ensure that maximum value is generated since it already has the power of decision-making to make it happen. The incomplete contract theory lags in specifying the appropriateness of the party to assume residual rights as it cannot set the ground rules for the identification of the party that has the most to gain from the exchange (Lu, 2019). Since market uncertainty does not allow the outcome of the exchange to be known, the selection of an appropriate party can be made with the aid of resource-based theory (Hart, 1988). Simply put, the party that gets to enjoy the most sustained competitive advantage in case of the realisation of the value of exchange gets to be the party with residual rights. It is also possible that more than one party is the holder of these valuable resources, which predicates the sharing of decision-making powers.

THE GOVERNANCE EFFECTS OF BEHAVIOURAL AND MARKET UNCERTAINTY

The impact of market uncertainty on governance does not rule out the impact of behavioural uncertainty. The choices made by governance in most situations are a direct product of opportunism under transaction cost economics or a high level of market uncertainty. It is apparent that in cases when the market and behavioural uncertainty are low, the choice of governance will be in favour of market form rather than hierarchical form (Pidot *et al*., 2015). This happens because market contracts are capable of countering opportunism and do not require extra expense on hierarchical governance to monitor the uncertain nature of the investment. The same is true with high behavioural uncertainty and low market uncertainty. Here, transaction cost economics stand parallel with discovery theory and market uncertainty stands parallel with creation theory. Both theories favour a hierarchical form of governance when behavioural and market uncertainty is high. However, in the case of low behavioural uncertainty and high market uncertainty, the prediction of the two theories becomes contradictory (Teece, 2016; Upson, 2017).

Transaction cost economics with opportunism under discovery theory suggests the sufficiency of a market contract for an exchange under low behavioural uncertainty. However, as discussed previously, appropriation of the value of exchange under high market uncertainty requires hierarchical governance (creation theory). The possibility of two theories being contradictory depends on the transaction being high in the market and low in behavioural uncertainty. The empirical nature of the correlation between the uncertainties allows the pointing out of transactions that are attributed to high market and low behavioural uncertainty. This made the behavioural uncertainty low but being a part of an enterprise with an uncertain future made the market uncertainty high. As most efforts to create business enterprises happened through firm creation, the two theoretical approaches cannot be tested rigorously in the context. It can also be assumed that two uncertainty situations do not move hand-in-hand in most situations. For testing of these theories, incorporation of forms of governance will have to be made that will add complexity to the situation.

DIFFERENCES IN THEORETICAL PREDICTIONS

The arguments presented in this study suggest that entrepreneurial firms may exist under creation theory as well as discovery theory approaches, but the firms created will be inherently different. Both theoretical stances support institutional frameworks that solve the difficulties of specific transactions. The difficulties are the opportunism threat and incompleteness of the contract. Discovery theory allows the value of exchange to be taken as given and aims to maximise the outcome, similar to transaction cost economics and incomplete contract theory. The value of exchange in creation settings is not known and this uncertainty is the primary difficulty that needs to be catered to. It is no coincidence that the theoretical stances that explain firm organisation consider the value of exchange as given while examining the implications of other transactions; they do not, however, predict the outcome of an uncertain exchange value in the first place (Wang, 2016; Williamson, 2019; Williamson, 2010).

DISCUSSION

In a sense, the two theoretical stances explaining entrepreneurial action stand in contradiction. If the conditions of one theory hold then the conditions of other theory cannot hold and *vice versa*. The existence of both theories in a simultaneous fashion in a purely empirical scenario cannot hold. This is an important implication of theory development in entrepreneurship. The intent to be inclusive has made some scholars in the field of entrepreneurship attempt to join the two theoretical stances together by handpicking the complementary assumption from the two theories. This study argues that such attempts are futile in the development of theory in the field of entrepreneurship. Also, the consistency of a situation with one theory at some stage does not predict the consistency of the situation with the other theory at a later stage.

As has been explained, entrepreneurs start their journeys in conditions that are consistent with creation theory where uncertainty is a common factor and individuals are constantly learning. However, this learning curve leads to a situation where conditions become apparent and the situation becomes consistent with the discovery theory. This happens when uncertainty transforms into risk and the objectivity of the opportunity becomes obvious. This process can also unwind in a different direction.

This study suggests that entrepreneurs act differently in the two situations, i.e., putting together plans to support decision-making in the discovery settings and constantly revising plans to support the fundamental assumption in the creation settings. This analysis does not say much about the transition time between the two situations. It is quite possible that both conditions might hold for some time, despite being in contradiction at a fundamental level.

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