

Sophistication or Multiplication: what happens to models of man when economists try to be more realistic.

Model of man in economic science (including motivational, informational and cognitive components) is a highly simplified and abstract representation of human nature used by economists constructing their theories. Without such models a systematic theory pretending to make definite conclusions and forecasts is impossible. In the history of economics we may perceive the periods when the model of man becomes more abstract. The marginal revolution of 1870-1890-ies and the formalist revolution of 1950-ies may be cited as examples. During such periods the analytic (mathematical) instruments used by economists become more powerful. But at the same time the tension increases between abstract assumptions of economic theory and economic reality. Resulting progress in economic theory consists of two subperiods: a stepwise deepening of abstraction and a gradual approximation to reality. During the second subperiod the model of man should be corrected without impairing the technical level just achieved. There are two ways of attaining this goal. The first one is to make the model of man more sophisticated, to loosen the simplifying assumptions. A typical example may be the bounded rationality model of Herbert Simon. The model becomes more sophisticated because the rationality assumption is weakened. But on this way the modelling technique becomes more complex, so the majority of economists tend to keep the more abstract old model of man. The second way presumes that we keep the old model of man but introduce an additional one that will take the burden of approximation to reality. This additional model should be used for a special group of economic agents.

An example of this approach is given by the theory of entrepreneurship. Entrepreneur could be considered the most specific and important actor in market economic system. But we can't get this impression if we look at economic theory. Entrepreneur and entrepreneurial function tend to belong to the periphery of economics. The reason for that consists in the very specificity of entrepreneurial activity which can hardly be simplified within economics. In order to write a theory of entrepreneurship one has to create a theory of exclusions. J.Schumpeter and L. von Mises follow different strategies to solve this problem.

Schumpeters approach: multiplication

In his magnificent "History of economic analysis" Schumpeter called Walras the most prominent economist so far as the pure theory is concerned. This however doesn't mean that Walrasian theory was an ideal for him. Economic science according to Schumpeter should also include such branches as economic history, statistics and *economic sociology*. These branches obviously require much less abstraction than the pure theory.

In "The theory of economic development" Schumpeter's main theoretical approach is the opposition between *Kreislauf* and *Entwicklung*. He sketches this approach by defining three pairs of opposites:

1. The constant unchangeable course of economic processes or a tendency towards equilibrium is contrasted with the violation of customary processes or economy changing its main parameters.
 2. Static theoretical approach is contrasted with a dynamic one.
 3. »Just master (Wirt) is contrasted with a specific actor – entrepreneur
- It can be asserted that in the Theory of Economic Development a model of man is a derivative from a model of the world. In the first chapter of the book, where the origin of Schumpeterian analysis – the Kreislauf - is described, we meet a “just master” as an actor. This is not a pure abstraction of a rational utility maximizer which is a necessary element of the equilibrium system of perfect competition. This could be said about the original actor of the theory of entrepreneurship of Frank Knight, but not about Schumpeter’s one. “Just master” follows the same path every day without deliberating about what he is doing. If for one reason or another he becomes thoughtful, he thinks about satisfying the needs of his family . And the habit turns these deliberations (for instance, about opportunity costs) into concise rules of a thumb – for example, a “cost plus” pricing scheme. The main behavioral principle of a “just master” is a quasi rational habit which serves a better satisfaction of needs. He chooses not the best existing way, but the most advantageous among the habitual ones. This behavioural principle closely resembles Alfred Marshall’s model of man in the “Principles of Economics”.

But what can we say about the alternative world where separate and discrete changes occur within the economic system itself? Apparently the Marshallian principle *natura non facit saltum* doesn’t work here. This principle is a good assumption when we consider the space where the wants of consumers are satisfied. But if our model of the world presumes radical shift we according to Schumpeter must turn to the supply side where entrepreneurs act. They are specific actors whose motivation is not connected with the satisfaction obtained from consumption. In case of success entrepreneurs pretty soon become well-off, but continue working without reducing their efforts. They hardly face a diminishing marginal utility function or compare the satisfaction from new goods with pains of labour. That means that they are not affected by the first and the second Gossen’s laws. One could argue that Gossens laws are valid only for a constant level of wants, which apparently rises with the growth of income. But the incessant entrepreneurial activity doesn’t leave the entrepreneur enough leisure for enjoying his well-being beyond a certain level. Entrepreneurs live in luxury, because they can afford it, but apparently they don’t work in order to live in luxury. This is not in line with the common sense and can even be considered a pathology. Entrepreneur’s motto is «Plus ultra». This corresponds to three groups of specific motives Schumpeter is writing about.

- 1.Foundation of ones own empire (sometimes a dynasty). This group of motives includes freedom, personal development, widening the sphere of influence, even snobism.

Реализацию этих мотивов мо The attainment of these goals which are alien to a “just master” can be measured by the growth of entrepreneur’s private property.

- 2.Motives of achievement, success for the sake of success. A natural criterion of success is profit, but it doesn’t coincide with profit maximisation of a neoclassical firm.

3. Joy of creativity, of the work process itself. Entrepreneurs are workaholics and not hedonists (this is confirmed by sociological surveys).

Information accessible to an entrepreneur is necessarily limited and doesn't let him take account of all direct and indirect consequences of his actions. This makes any profit maximization virtually impossible.

As for the entrepreneur's intellect it is characterised by a specific combination of sharp vision and limited worldview. Schumpeter anticipated here his future ill 1925. detour to politics and business from 1918. It may be simply dangerous for an entrepreneur to think logically and systematically. Not the width and depth of intellect but a boundedness of a special kind, an ability to select some aspects of reality is relevant for an entrepreneurial activity. Limited information presupposes an important role of intuition which can separate relevant and irrelevant circumstances without sufficient knowledge.

Next qualities concern will-power. Schumpeter's entrepreneur is a person swimming against the currents of various kinds. There are political and legal obstacles, public disapproval facing any dissenting behaviour, not mentioning opposing interest groups. Besides an entrepreneur has to persuade needed allies to follow him and make potential consumers like his product. He has to possess "charisma" or "Fuehrerschaft" using Schumpeter's word.

But an entrepreneur needs will-power to overcome not only numerous external obstacles but also his own inertia or laziness.

It looks that the model of entrepreneurial personality by Schumpeter is very close to real entrepreneurial traits. But it is still an ideal type, an abstraction. A clear proof of this is the absence of entrepreneurial risk postulated by Schumpeter. The function of risk-bearing is fulfilled in Schumpeter's system by money lenders, providing credit to entrepreneurs. This certainly an artificial assumption: real entrepreneurs, even if they don't bring any money to their enterprise, risk their reputation, self-esteem, efforts and time. This important circumstance was stressed by all the theorists of entrepreneurship since Cantillon.

Discussing the distribution of entrepreneurial type among the population Schumpeter compares it with distribution of vocal abilities. Nearly everybody can sing, but remarkable vocal abilities are possessed only by a few. The borderline between entrepreneurs and "just masters" is very pronounced though nobody can be engaged in entrepreneurial activities during the whole life.

Ludwig von Mises – the strategy of sophistication.

Mises, Schumpeter's colleague at Vienna University and Boehm-Bawerk seminar solved the entrepreneurship problem in a different way. In his "Human Action" he made the original model of man somewhat more complex, endowing it with entrepreneurial traits. According to Mises a human action is by definition goal-oriented. It involves decision making and not just expression of preferences, though real labour is not necessary. A refusal to consume is also an action.

Conditions of an action are 1. the dissatisfaction with the current state of affairs, 2. Conception of a more satisfactory state and 3. Expectation that an intentional behaviour can reduce the discontent. Every human being always aims at achieving a higher degree of satisfaction even if it is connected with altruistic deeds.

According to Mises a human action is rational by definition though it doesn't mean utility maximization but only intentionality. We can't say that Mises used the marginalist model of utility maximizer (the same can be asserted about Schumpeterian "just master"). Here the Austrian heritage of both authors and their belonging to Menger's school plays an important role. But an Austrian conception of rationality implies that human beings are vulnerable to errors while choosing the appropriate means to attain the goal

Unlike Schumpeter Mises believed that a static method using an ideal model of an evenly functioning economy is the only possible way of exploring all the changes, small or big, slow or sudden. So to investigate the entrepreneurial function we only have to drop the assumption of constant data. Then the outcome of each action would become uncertain and all kinds of activity will become speculative. In a real economy following Mises all actors (including land-owners, workers and consumers) are speculators= entrepreneurs.

So a Misesian entrepreneur is a person whose actions are guided by the changes in market information (probably, Cantillon would agree to this definition).

Mises also mentions the uneven distribution of entrepreneurial activities among the population. He introduces a figure of "promoter" - an entrepreneur who doesn't sell labour, natural resources or money. This means that promoter is an entrepreneur in industry or trade. He is a leader who tries to make profit as high as possible. But promoter according to Mises can't be strictly characterized praxeologically (by Schumpeter entrepreneur was given a very strict theoretical definition).

Unlike Schumpeter Mises is true to the principle of consumer sovereignty. "Entrepreneur is steering the ship, but consumer is the captain". The only exclusion from this rule is the case of monopoly profit (Let us remember that by Schumpeter entrepreneurial activity manifests itself in a temporary monopoly).

Summing up we have to deal with two strategies of making the economic theory more realistic so that it could embrace the phenomenon of entrepreneurship. The first one stresses the specificity of entrepreneurial function, the second one stresses its ubiquity.

Another example of the same situation could be the theory of financial markets. The theory of efficient markets assumed that the participants of financial markets are highly rational experts, able to calculate an optimal choice in no time. But R.Shiller and others discovered a lot of anomalies signalling irrational behaviour in financial markets. They could be explained either by making the model of man less rational (as in the behavioural finance) or introducing an additional agent - a layman led by irrational impulses.