

# Resurrecting the Ghostly Entrepreneur

by Henry G. Manne

The real intellectual struggle about the analysis of entrepreneurship is that between Israel Kirzner (1973) and Harold Demsetz (1983). Kirzner is the great champion of entrepreneurial studies, analytical and perhaps even institutional, and Demsetz is the rationalizer of the professional neglect of the entrepreneur. He is not even sure that such an actor exists or that there is a distinctive entrepreneurial function. Oh sure, Frank Knight (1921) and Joseph Schumpeter (1934) had a lot to say about entrepreneurship, and comparing their analysis to Kirzner's once became something of a cottage industry itself.<sup>1</sup> But that is small potatoes compared to the tension Demsetz has created for the very enterprise of studying entrepreneurship.

Schumpeter famously related entrepreneurship to the business cycle with his theory that entrepreneurs entered the fray during recessionary and static periods of equilibrium when prices were low, innovating and thereby energizing the economy. In other words they were the drivers of "creative destruction", forcing a new disequilibrium and economic progress. Kirzner's view seems diametrically opposite to this, though with consummate kindness he is at great pains to insist that his and Schumpeter's views overlap considerably. For Kirzner the entrepreneur is inspired to enter the fray when some disequilibrium has already occurred, since he

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<sup>1</sup> See for example Klein and Briggeman (2010) and the responses to that article in *The Journal of Private Enterprise* 25(2).

or she is alert to the opportunity to make profits by re-equilibrating the margins of revenue and cost.

Knight did not have a horse in this particular race. Indeed Knight's great contribution to this area is his description of "profit" as the residual left over after the entrepreneur has paid the contracted amounts to all the other factors of production. This profit is related in the Knightian system to the notion of "uncertainty" and the assumption of risk by the entrepreneur. This in turn leads to the conclusion that entrepreneurial profits cannot be sought to be maximized in advance. Indeed Professor Knight devotes considerable space to a question Kirzner deems irrelevant, that is, whether on balance and in aggregate entrepreneurs even receive positive returns. To this Kirzner (1973: 83) rejoins that while the amount of profit is inherently unpredictable, it is still the "search for profit opportunities which...is the essence of the entrepreneurial role." As we shall see, this issue is simply subsumed in later, more expansive discussions of entrepreneurship, and the ongoing conflict, pre-Demsetz, seems to be much more Kirzner vs. Schumpeter than Kirzner vs. Knight.

All three of these theorists shared two common assumption, one, that the entrepreneurial function exists as an independent and objective input into the productive order and, two, that the entrepreneur's reward was always in the form of the residual left after all other productive inputs had been paid for. To be sure, none of the writers ever made explicit exactly what the nature of this input was, apart perhaps - and often only by implication - from starting up a new firm.<sup>2</sup> And none of them ever addressed the issue of how to distinguish entrepreneurial compensation from the return to other factors of production with which in practice

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<sup>2</sup> For some elaboration of a broader notion of entrepreneurial activity, see Manne (2011) and Klein (2008)

the entrepreneurial function was usually tied. And certainly none of them ever sought to measure it.<sup>3</sup>

But Kirzner's analysis sharply differed from the other two in the extent to which he emphasized the entrepreneur's ongoing role as trying to profit from disequilibria, that is, his being a kind of cosmic arbitrageur. Without someone's serving this function there would presumably be utter chaos. Schumpeter on the other hand, starts his analysis with a static equilibrium world which the entrepreneur upsets the status quo - and creates economic development - by innovation and new forms of competition. His entrepreneur, like Kirzner's, is a profit seeker, but his role in the larger market model is quite different. He drives economic development, and, without this functionary, we would all be doomed to static oblivion.

While the theory of risk and uncertainty (and eventuation of the unpredictable) is mostly associated with Knight's name, it is Kirzner who develops the idea of a distinctive role for the entrepreneur by focusing on his or her alertness to discover profitable opportunities that the real, dynamic and unpredictable world churns up willy-nilly for successful entrepreneurs.<sup>4</sup> But it should be acknowledged that, as a matter of fact, Schumpeter never actually claimed the static equilibrium to be anything other than an analytical starting point. It was not intended as a

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<sup>3</sup> Knight did, of course, famously assume that the world received its entrepreneurship for zero or negative costs, but there is no strong evidence one way or another on this. For some attempts to measure the returns to entrepreneurial activity, see Astebro (2003) and Nordhaus (2004).

<sup>4</sup> Knight did have a concept of entrepreneurial "judgment," which might be seen as a parallel concept to Kirzner's alertness. However, he did not make this central to his theoretical development.

description of reality.<sup>5</sup> Arguably there is less actual difference in these various schemes than their rhetorical formulations would suggest.

But there is still plenty of room for skepticism and correction with these classic formulations of the entrepreneur's role. Harold Demsetz, in a brilliant but generally unheralded short essay in 1983 addressed most<sup>6</sup> of the issues raised in the preceding few paragraphs and raised questions that should today be front and center in any discussion of the entrepreneur. He begins with a discussion of the classical economists' neglect of the entrepreneur, a matter clearly noted by Kirzner, Schumpeter and Baumol (2000, also Baumol, Robert, and Schramm 2007). His explanation is persuasive as far as it goes. It is that the classical economists, though obviously familiar with entrepreneurship and innovation, were for the most part not really concerned with either change or economic development. Their focus was on explaining how a "decentralized economic system allocated resources", and this understanding would have been delayed had they jumped ahead to explore change. There was a remarkable intellectual achievement but not one that lends itself to integration of a theory of the entrepreneur, the agent of change.<sup>7</sup>

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<sup>5</sup> It was perhaps intended to be something like Dante's *Inferno*, a frightful warning to evil doers, or, in Schumpeter's case, to those who would seek to interfere with innovation and progress. But in this connection it is well to keep in mind Demsetz' warning that the classical economists were only trying to explain how a decentralized system would work to allocate resources to their most efficient use. They were not trying to explain more than that, and a great deal of criticism of their work simply misses this point. See Demsetz (2011) for a more recent use of this distinction, this time addressing market criticism based on transaction-costs arguments..

<sup>6</sup> Not all the issues, since he did not address the compensation issue mentioned in the text nor did he discuss the nature of "profits".

<sup>7</sup> "Entrepreneurship was neglected because the problems of economic change would simply have made it more difficult to focus on the coordination problem." (Demsetz 1983: 274). This bifurcation of concerns might also help us understand the organization of Knight's classic *Risk, Uncertainty and Profit*, the first part of which is a description of the perfect competition model. Still, as a justification for the classical writers' not paying more attention to change, this is fairly weak gruel. Baumol similarly blames modern theory of the firm for the absence of entrepreneurial studies, since the classic formulation of this theory implied a static model with no room for change. (Baumol 2000: 14-15)

The post-classical period of economics, continues Demsetz, starting with the depression of the 1930s, raised new barriers to concern about the entrepreneur. Now the focus was upon market failures and how the government should address macro-economic problems, neither concern of which was conducive to study of the entrepreneur. We might also note that the spurt of interest in entrepreneurship in recent years has had little to do with theoretically analyzing an economic function called “entrepreneurship” and much to do with encouraging and measuring economic development.<sup>8</sup>

After this brush with broad intellectual history Demsetz addresses both Schumpeter and Kirzner with a withering critique of the former and a somewhat more sympathetic view of the latter. Schumpeter gave a very large role to the entrepreneur as the moving force behind both business fluctuation (entrepreneurial actions are knowingly counter-cyclical) and economic development (as the moving force of creative destruction). But Demsetz (1983:275) finds the Schumpeterian entrepreneur to be “neither an object of analysis nor of research, but is rather a *deus ex machina* of economic change.” In other words, there is less there than meets the eye, a shadowy concept without flesh and blood. Schumpeter’s success in having this become an accepted part of the current entrepreneurial canon Demsetz attributes to Schumpeter’s promotional skills rather than the force of his idea.

When he combines Schumpeter’s creator of disruption with Kirzner’s creator of equilibrium, Demsetz (1983:276) declares that neither of them has really identified a distinctive economic actor, since what is being described is really

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<sup>8</sup> See Baumol, Litan and Schramm (2007).

nothing more than mundane profit maximization. “The new element,” he declares, “is really not the entrepreneur - it is the expanded opportunity set for maximizers... [in] a context in which knowledge is costly and imitation is not instantaneous.”<sup>9</sup> Thus Demsetz comes quite close to arguing that there is no explicit entrepreneurial function at all.

But, at the very last moment, as it were, he finds that Kirzner has indeed found one characteristic that distinguishes entrepreneurs from all other profit maximizers, and that characteristic is *alertness*. Alertness, for Kirzner, has a very special and subtle meaning. It is decidedly not simply having superior knowledge, since that can always be bought in the open market for factors of production. Rather it is the ability to distinguish certain opportunities, not by superior knowledge or calculation (as Schumpeter would have it), but simply by being more alert to the opportunities presented. Of course, when the same individual acts on his discovery of a profitable opportunity, he becomes or contracts for one or more of the usual factors of production. Nonetheless, his alertness is distinguishable from the role of the passive economizer. This feature is said to be costless and allows Kirzner to conclude that there is a “pure entrepreneurial” function.

If this all seems rather abstract and unrealistic, Kirzner (1973: 41) anticipates that objection. His “pure entrepreneur” is not intended as a description of a real live individual. Rather it is an heuristic device to help us better understand how market circumstances change over time, something traditional, classical theory did not allow for. Kirzner (1973:43) finds it “expedient” to separate out the pure economizer from the pure entrepreneur for analytical purposes, and this does

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<sup>9</sup> This powerful criticism applies as well to many other theories of the entrepreneur. See, Klein (2008).

indeed allow a transformation of the static classical model into a more dynamic market process model, not a small accomplishment.

But Demsetz (1983:277) is not to be so easily satisfied. While not disagreeing with Kirzner's scheme of analysis, he does reduce its significance. "If this is the essence of entrepreneurship, there is a more familiar name for it - luck." He sees this function as a "stumbling into a profit opportunity... without any deliberate, focused investment of time, energy or other resources," in other words, good luck. And while he doubts that alertness is really achieved at zero cost<sup>10</sup>, he does acknowledge that "this cost would trivially differ from zero in many instances."(Demsetz 1983: 278)

But Demsetz (1983:278) gives and he takes away, for in the very next paragraph he concludes that "the term entrepreneur is useful grammar...it adds no new economic agent or variable to the study of competition under conditions of imperfect knowledge. This is true even though such risk-bearing planned ventures may be *the most important source of economic progress*" (emphasis added). In other words, he suggests here that Knightian risk taking may be more significant in economic development than is Kirznerian alertness. Regardless of the outcome of that empirical issue (i.e. how much of progress results from costless luck and how much from costly search), even acknowledgment of the issue would seem to weaken the thrust of Kirzner's entrepreneurial theory.<sup>11</sup>

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<sup>10</sup> One is reminded of the profound lesson of the great golfer, Gary Player, who pointed out that "the more I practice, the luckier I get." Tyler Cowen (2003) also belittles Kirzner's "costless" alertness while offering a "poetic" version of the entrepreneur as being similar to Kant's aesthetic genius, less different from Kirzner's entrepreneur than might first appear.

<sup>11</sup> "But even if this pure component is the more important source of economic progress, it is, in a sense, beyond the scope of scientific analysis." Demsetz (1983:278)

At this point, Demsetz, one of the fathers of modern property rights theory, demonstrates a very uncharacteristic lack of alertness, a moment of Homeric nodding. Having made his point that alertness is usually a form of investment under conditions of uncertainty, he follows up with what he apparently sees as the main implication of that insight:<sup>12</sup> “If the political system allows persons to retain a larger fraction of the profit created by being alert to lucky events, there will be more alertness - a response difficult to reconcile with a belief that alertness requires no resources.” (Demsetz 1983:279) But the point he misses here is not some mystical quality in the entrepreneur; rather it is the advantage of recognizing a distinctive kind of productive input - *in which one can have some form of property right* - not generally considered in the neoclassical market model, an input closer to Kirzner’s alertness than it is to Demsetz’ luck, though perhaps with elements of each, what I will call “the idea.”

Demsetz’ point about the political system actually suggests a more robust theory of entrepreneurship than he recognized, and, interestingly, one that to a considerable degree reconciles the various positions we have been discussing. For it is the political system that determines the dimensions of the property rights someone may have in a new invention, production or venture, usually with either a patent or a copyright<sup>13</sup>. And, while I do not mean to confound entrepreneurship and innovation any more than they already have been, a consideration of those devices may give us new insights into the real nature of entrepreneurship. The thing that each of these political creations of property rights has in common is the

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<sup>12</sup> Though he would probably say that he was only critiquing Kirzner here and not adducing a new theory. Be that as it may, he does not notice the obvious property-rights relevance of what he says.

<sup>13</sup> We could add trade secret to this mix, but just considering patent and copyright simplifies the analysis, especially since the trade secret mode of protection is not generally considered to exist by virtue of the political system.

notion of protecting the original idea, a notoriously difficult task.<sup>14</sup> And yet what the entrepreneur is doing is selling his idea; everything else is basic Economics 101. The “price” the will receive may well be termed “profit” in the usual sense, but this is clearly not a market-price process.

The problem here (and this may mean that we have misspent a large effort on trying to analyze the entrepreneur) is how to recognize a property right in a new idea when it is still merely a mental concept. A moment’s reflection will show that, outside of cocktail party chatter, this simply cannot be done, even though it would be highly desirable from a welfare point of view if we could do this cheaply and would induce the production of more ideas. If we could identify and protect a real property right in mere ideas, then the problem of the entrepreneur would be solved. The entrepreneur would be simply the owner of a transferable property right in his or her new idea. Everything else would fit neatly into the neoclassical market paradigm with no need for abstruse analysis or mysticism. In this regard a comparison to patent and copyright law and economics is revealing.

Both patent law and copyright law are characterized by their effort to distinguish the thing to be protected from that which is common property.<sup>15</sup> Thus one cannot get a patent or copyright protection for a disembodied idea; the idea must be shown to be applicable to something concrete and new, and that object must be either physically presented or adequately described to the Patent Office for

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<sup>14</sup> Consider, as an example, the normal practice of business firms to send back unopened or undirected to a relevant person any suggestion for a new product or other innovation. This is done regularly to protect against law suits claiming prior property rights in something the company was already considering in any event.

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a patent to issue. This requirement (and the parallel one in copyright) relates to some aspects of property rights economics that we have come to understand largely through the great work of Professor Demsetz. The idea of a property right in a disembodied idea would run afoul of the notion that to have a secure property right, the dimensions of the thing being protected must be ascertainable, the boundaries of protection discernible and the protection feasible.

So a great problem in economics may be seen as the difficulty in designing a system which will encourage the production of useful ideas that are subject to protection neither by patent or copyright.<sup>16</sup> Consider the case where the idea is merely to start a new hamburger restaurant at a certain location. This idea is certainly not patentable or in itself copyrightable, so how can we reward and motivate such ideas? We are not referring here to notions of economic growth; rather the issue is what would be the theoretical characteristics of a motivating force for new ideas within the context of a private-property, open-market system.<sup>17</sup> Traditionally the characteristics of first-mover advantage have been thought to be sufficient to protect the idea<sup>18</sup>, but only when the idea has been attached to or integrated with bricks and mortar. Just as a “patentable idea” is not really protected until it is joined with something physical or just as a literary work is not protected until it has been reduced to a tangible manuscript, the entrepreneurial idea cannot be the subject of a property right until it has been integrated into something physical, tangible or otherwise subject to practical protection. The same

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<sup>16</sup> Klimis and Wallis (2009) examines whether existing patent or copyright institutions in fact encourage the production of ideas that fall under their protection.

<sup>17</sup> Most current literature is, however, concerned with the “growth” issue, normally in the context of discussions of underdeveloped economies, such as Baumol, Litan and Schramm (2007)

<sup>18</sup> Ibid. (2007:3)

reasons that Demsetz early gave us for having such a requirement in patent or copyright law also hold for entrepreneurship.<sup>19</sup>

This shows how easy it is to equate and confuse entrepreneurship (here the idea) with establishing a new firm (first-mover advantage), but that is entirely unsatisfactory from an analytical point of view. The thing that is distinctive here is the idea, and the economic canon would do well to open its doors wide to a new member of the famous productive trilogy of land, labor and capital. Surely Demsetz overreaches<sup>20</sup> when he suggests that having ideas is always the same as securing new information, which, by implication, can be purchased in the open market, thus denying any new role for the concept of the entrepreneur.

But there is a peculiarity to new ideas that makes recognition of a property right therein difficult. It goes to the requirement of property rights theory that the thing to be protected must be identifiable for the protection to be feasible. That is why the law only protects ideas through patents once the idea has been demonstrated in a physical fashion or a poem can be copyrighted only after it has been physically published. And so it is with entrepreneurial ideas. They will not be protected until the idea has been attached to a production process or a new product or a new business or whatever that is identifiable for the simple reason that there is no feasible way to do so. This is why in the standard literature we read that the entrepreneur must generally also be a capitalist or a manager or a supplier. That is

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<sup>19</sup> See Demsetz(1967)

<sup>20</sup> Though one could easily find circumstances in which the idea of a new idea itself is contracted for, say a contract to invent or do research, and that in turn would take the invention or research finding idea out of the realm of the entrepreneurial and into the realm of a particular kind of labor service with an ascertainable market price. That feature alone distinguishes the entrepreneurial from the merely inventive.

so only because, as a practical matter, there simply is no way to protect an entrepreneurial idea without combining it with some other inputs.

We can talk about a new business as being an entrepreneurial enterprise with no real loss of practical value, since at that point the property right in the physical object is secure. But the entrepreneur cannot secure the benefits of a property right in his or her idea until and unless the idea is attached to some more familiar productive input in which a traditional property right is recognized. This goes a long way to explaining the confusion endemic in the literature between “pure entrepreneurialism” and innovation or start ups or invention. The former does in fact exist, as Kirzner claimed, but only the latter can be the subject of an effective property right. It also explains the confusion about identifying or measuring entrepreneurial returns. Since the idea cannot be exploited (i.e. a property right recognized) apart from a combination with other inputs, it will always be difficult if not impossible to evaluate the components separately.

This notion of entrepreneurship as representing an effort to establish a property right in an idea bears some similarity to Kirzner’s alertness, though the idea of “the idea” does not connote anything about the mental machination necessary to produce the result, as the idea of alertness does. It can come in a “flash, it can come in a dream, or it can come through studied effort to derive a new idea. That is a matter of psychology that does not really interest us here. And while Demsetz is correct that if laws protect these ideas there will be more of them produced than if they remain common property (his basis for criticism of Kirzner’s idea of alertness’ being costless), that point, essential to Kirzner’s entrepreneurial theory, is no longer terribly significant. There is no reason to assume that this fourth input into the productive process would not respond to the traditional

motivating forces just as the other three do, though it may have other other inspirational geneses as well. The “entrepreneur” as a real identifiable functionary is now secure from Demsetzian obliteration, and he no longer requires mysticism or a leap of faith to recognize his or her existence and role in economic theory.

By seeing the idea as a separate kind of productive input, we can now assimilate the strong parts of Schumpeterian theory into the mix. There is nothing about this concept that contradicts his theory of economic development or that would dissuade us from adopting policies which will encourage the formation of ideas which, in combination with other inputs, will enhance economic growth. The new part of this approach is regarding the idea as a separate and unique productive input that must be incentivized in its own distinctive fashion.<sup>21</sup>

Since any given idea for a new enterprise is inherently uncertain, the idea of “the idea” as being the main analytical characteristic of the entrepreneur does not conflict in any way with Knight’s formulation. All the ideas of risk, uncertainty and, indeed, of profit as the remuneration to the entrepreneur remain intact. All the studies of business founders, inventors and commercial innovators still retain their place in the comprehensive study of entrepreneurship. But, hopefully, one obscure piece of the theoretical puzzle is now brought into the open.

There remains one interesting and puzzling aspect of this picture. While it is certainly not inappropriate to talk about “profit”, however, calculated, as the measure of the return to the new-firm entrepreneur, that is no answer to the question of the entrepreneur’s role in the large, publicly-held corporation, where

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<sup>21</sup> That implicates a role for psychology, education and culture in a full blown theory, but the present effort is merely to resurrect the concept of the entrepreneur as a useful and practical one.

entrepreneurialism and innovation are certainly not unknown. Schumpeter famously predicted the demise of such corporations for the reason that they could not encompass real entrepreneurs, without which they would become stagnant and wither away.<sup>22</sup> We know he was wrong about that, and consideration of whatever it is that does preserve entrepreneurialism in large corporations will help us understand the true nature of the function.

We have seen that research skills can be bought in the open market for a known market price. But we have also seen that there is a distinctively entrepreneurial function that cannot be bought in precisely quite the same fashion. There is no market price, and one cannot construct a meaningful supply curve. We know that the true entrepreneur within a large corporate organization will, as all persons do, respond differently to different forms of compensation. He or she may well be willing to work for a salary, with bonuses and stock options allocated after the fact.; corporate laboratories are full of such people. But the real entrepreneurial part of that picture was in the original idea to hire researchers, not in their results.

So we know that for a market determined price we can buy research, but how can a corporation buy entrepreneurial services when no one can know what price needs to be paid, and no amount of ex post negotiating will guarantee the next entrepreneurial innovation. The answer clearly lies in understanding the character of the entrepreneur, an approach that Frank Knight, more than anyone else, seems to have focused on, and the word that sums up Knight's view of the matter is "optimism".<sup>23</sup> So how can we design a compensation system that will generate optimism among employees and potential employees and will not require either

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<sup>22</sup> See Schumpeter (1943) pt. 2 ch 12,14.

<sup>23</sup> But whether we focus on Knight's "optimism" or Kirzner's "alertness," or even Demsetz' "luck", the question of how to compensate for this function will remain

advanced knowledge of what they may produce or require ex post negotiating to settle on values? The only compensation system that can meet all these requirements is permitting stock trading by anyone on undisclosed knowledge of potential stock price changes. But note, this is not a system for setting individual compensation; it is rather a system of compensation that will encourage entrepreneurial spirit.<sup>24</sup> There will be some “unfairness.” So what?

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<sup>24</sup> For a greater elaboration of this point, see Manne (2011). Note the logical fit with the point implied above in the text that the entrepreneur is “selling” his idea, exactly what needs to be accomplished in the large corporation setting but which current laws on insider trading prohibit.

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