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## Capitalist Entrepreneurship: Making Profit through the Unmaking of Economic Orders

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## Abstract

This is a theoretical paper in which we attempt to present an economic and sociological theory of entrepreneurship. We start from Schumpeter's idea in *Theory of Economic Development* that the economy can be conceptualized as a combination and innovations as new combinations. Schumpeter also spoke of resistance to entrepreneurship. By linking the ideas of combination and resistance, we are in a position to suggest a theory of capitalist entrepreneurship. An existing combination, we propose, can be understood as a social formation with its own cohesion and resistance – what may be called an economic order. Actors know how to act; and profit is low and even in these orders. Entrepreneurship, in contrast, breaks them up by creating new ways of doing things and, in doing so, produces entrepreneurial profit. This profit inspires imitators until a new order for how to do things has been established; and profit has become low and even once more. Entrepreneurship is defined as the act of creating a new combination that ends one economic order and clears the way for a new one. The implications of this approach for a number of topics related to entrepreneurship are also discussed.

## Introduction

Economic analysis has suffered deeply from the split that was opened up around 1900 between neoclassical theory on the one hand, and a social approach on the other; and the theory of entrepreneurship is no exception in this regard.<sup>1</sup> One important goal for the analysis of entrepreneurship is therefore to develop a theory that in an analytically powerful way brings together and integrates the two parts of economic analysis that were forced apart a century ago.

In the case of entrepreneurship this may well be considerably more difficult to accomplish than for many other forms of economic phenomena. The reason for this is that economists, by tradition, have not paid much attention to entrepreneurship. With the exception of Schumpeter (and later Kirzner and Baumol), few of the major economists have worked on entrepreneurship. Why this is the case has much to do with the following fact: entrepreneurship is hard to analyze with equilibrium theory; and this type of approach has dominated mainstream economic theory since around 1900.

One reason why it is especially important to integrate both a social and an economic perspective in a theory of entrepreneurship is that entrepreneurship, more or less by definition, deeply affects not only the economic sphere but also the social sphere. The social structure of the economy is upset by entrepreneurship when some new economic activity is created. But entrepreneurship also directly influences a number of non-economic areas of society, from family life to stratification. Creative *social* destruction accompanies creative *economic* destruction (and also affects it in its turn).

In this article we will try to show what a theory of entrepreneurship may look like that integrates a social with an economic approach. The article, it should be emphasized, is theoretical. Our theory attempts to capture the dynamics of what we term *capitalist entrepreneurship*. We argue that it is important to realize the difference between a general theory of entrepreneurship and one that deals with entrepreneurship in a capitalist economy. The entrepreneur in a capitalist society has to produce a profit, with the help of capital, as opposed to say the entrepreneur in a socialist economy, where the goal is the generation of wealth (e.g. Weber, 1978:86-100). The presence or absence of the imperative to make a profit makes a qualitative difference. Today there also exists a proliferation of expressions that refer to different types of entrepreneurship – political entrepreneurship, institutional entrepreneurship, social entrepreneurship and so on

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– and this is another reason why it is important to specify that we are dealing with a theory of capitalist entrepreneurship.

The problem, as always, is to know where to begin; and in our case we will start with what we consider to be the most promising theory of entrepreneurship so far, namely that of Schumpeter.<sup>2</sup> What makes his theory of entrepreneurship so attractive, to our mind, is his idea that entrepreneurship can be conceptualized as *a new combination* of already existing economic means. In the classical formulation of *The Theory of Economic Development*:

To produce means to combine materials and forces within our reach. To produce other things, or the same things by a different method, means to combine these materials and forces differently...Development [or entrepreneurship] in our sense is then defined by the carrying out of new combinations. (Schumpeter, 1934:65-6)

As we shall try to show in the next two sections of this article, Schumpeter's theory contains some ideas that can be used very effectively as one's point of departure for a capitalist theory of entrepreneurship.

In presenting his theory of entrepreneurship Schumpeter also makes use of the helpful fictions of, on the one hand, an economy with no entrepreneurship and, on the other hand, an economy that is entrepreneurial in nature. The former is discussed in Ch. 1 in *The Theory of Economic Development* and called "*the circular flow of economic life*". The latter is the focus of Ch. 2 and referred to as "*economic development*".

In the circular flow type of economy everyone clings to habitual economic methods. All impulses to change come "from without", which leads to very slow changes or "adaptation" (Schumpeter, 1934:33, 63). "In every economic period the tendency exists to turn again into the former well-worn tracks" (Schumpeter, 1934:39).

By contrast, when the economy is in a state of "economic development", new combinations are put together and change comes "from within" (Schumpeter, 1934:63). While decisions are taken by "managers" in the circular flow, in economic development they are taken by "entrepreneurs".

Does Schumpeter view capitalism as inherently entrepreneurial or, to phrase it differently, does he argue that it is capitalism (or say "the market") that ultimately explains entrepreneurship? The answer is "no". The reason for being so affirmative on this point is that both the circular flow-economy and the type of

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<sup>2</sup> See Becker and Knudsen (2009) for a recent summary of Schumpeter's works and its implications for organization of entrepreneurship. For a general introduction to Schumpeter's life and work, see Swedberg (1991) and McGraw (2007).

economy characterized by economic development are capitalistic, in the sense that they both assume a society in which there is “private property, division of labor, and free competition” (Schumpeter, 1934:5). What then constitutes the main difference between the two? The answer is *entrepreneurship*. Capitalism, in brief, according to Schumpeter may become bogged down in a non-dynamic type of capitalism. It can also be dynamic and entrepreneurial.

## Schumpeter on Combinations

The central concept in Schumpeter’s theory of entrepreneurship is that of *combination*, both for the work it does in his own theory and for its general potential for theorizing and explaining entrepreneurship (Swedberg, 2007). Why does Schumpeter use the concept of combination in his theory of entrepreneurship and where does it come from?

Schumpeter refers to the work of 19<sup>th</sup> century economist Jean-Baptiste Say on this point:

His contribution [to the theory of entrepreneurship] can be summed up in the pithy statement that the entrepreneur’s function is to *combine* the factors of production into a producing organism. Such a statement may indeed mean much or little. He certainly failed to make full use of it and presumably did not see all its analytical possibilities. He did realize, to some extent, that a greatly improved theory of the economic process might be derived by making the entrepreneur in the analytic schema what he is in capitalist reality, the pivot on which everything hinges. (Schumpeter, 1954:555).

Schumpeter distinguishes between the following two cases: there exist new combinations as well as already existing combinations. New combinations are defined as innovations by Schumpeter. And there are five main types of innovations: “a new good”, “a new method of production”, “a new market”, “a new source of supply of raw materials”, and “the carrying out of a new organization of any industry” (Schumpeter, 1934:66).

If innovations are new combinations, according to Schumpeter, what does he have in mind when he refers to combinations that already exist? The answer can be found in Schumpeter’s discussion of “economic combinations” versus “technological combinations”. The central argument is as follows:

Technologically as well as economically considered, to produce means to combine the things and forces within our reach. Every

method of production signifies some such combination. This concept may be extended even to transportation and so forth, in short to everything that is production in the widest sense. An enterprise as such and even the productive conditions of the whole economic system we shall regard as ‘combinations’. (Schumpeter, 1934:14)

Combination, then, is a term that Schumpeter also uses to capture the process of production – what Say called a “producing organism”. While it is often said today that the economic process consists of “production, distribution and consumption”, Schumpeter can – with a little stretch – be said to suggest a different way of conceptualizing it: as a combination.

Why does Schumpeter make a distinction between technological and economic combinations? The answer has to do with the fact that the economic process can be organized according to different criteria. If technological criteria are prevalent, the technologically most efficient solution will be chosen. But in a capitalist society, “economic logic prevails over the technological” (Schumpeter, 1934:14-5). He adds: “in consequence we see all around us in real life faulty ropes instead of steel hawsers, defective draught animals instead of show breeds, the most primitive hand labor instead of perfect machines, a clumsy money economy instead of cheque circulation, and so on” (Schumpeter, 1934:15).

## **Schumpeter on Resistance to Innovations**

According to Schumpeter, the concept of combination plays a key role in his theory of entrepreneurship, but there are other concepts as well (Schumpeter, 1934:14). The second most promising concept that we want to highlight is *resistance to entrepreneurship* (cf. Swedberg, 2007).

As already mentioned, the idea of resistance to entrepreneurship is present in Ch. 1 on the circular flow in *The Theory of Economic Development* (1934). Schumpeter mentions, for example, how the farmer, because of tradition, keeps repeating his production year in and year out. Tradition has “bequeathed him definite means and methods of production [and] all these hold him in iron fetters in his tracks” (Schumpeter, 1934:6). But Schumpeter does not single out the element of resistance in Ch. 1, and the reader does not understand how central it is to his theory of entrepreneurship until he or she reaches Ch. 2 on economic development or entrepreneurship.

In this chapter one can find a much fuller and more systematic discussion of resistance to innovation than in Ch. 1, and also an argument how it can be overcome. Resistance to entrepreneurship, Schumpeter says, comes in three types. There is the resistance associated with “*the task*”; resistance associated with “*the*

*psyche of the businessman*"; and resistance from "*the social environment*" (Schumpeter, 1934:86).

By resistance to a new task, Schumpeter means that the economic actor will have to do something that he or she has never done before. As a result, the actor lacks "data" for his or her decision as well as "rules of conduct" (Schumpeter, 1934:84-5). The economic actor "must [now] really to some extent do what tradition does for him in everyday life, viz. consciously plan his conduct in every particular". Since it is impossible to figure everything out, a decision has somehow to be made anyway. This means that *intuition* has to be used; "the success of everything depends on intuition" (Schumpeter, 1934:85).

The second type of resistance is to be found in the person him or herself – in the way that he or she thinks and feels about doing something new. People have an inborn tendency to avoid what is new, Schumpeter says, as exemplified by the fact that people are reluctant to innovate even when there exists no objective resistance. Once you have settled into a routine, Schumpeter specifies, "thought turns again and again into the accustomed tracks" (Schumpeter, 1934:86). To break away from these routines is difficult, and few people have that "great surplus of force" or "mental freedom" that is needed for this (Schumpeter, 1934:86).

The third type of resistance consists of "the reaction of the social environment" and includes, first of all, "legal or political impediments" (Schumpeter, 1934:87). More important, however, is the hostility that people show towards those who behave in a different way. Schumpeter notes, for example, that people are quick to spot and condemn differences in dress and manners. This resistance is especially strong when a group has a material interest in the status quo.

The strength of this hostility can be illustrated with an example from *Business Cycles*. In his discussion of early European economic history Schumpeter says that "entrepreneurs were not necessarily strangled but they were not infrequently in danger of their lives" (Schumpeter, 1939:Vol. 1, 243). To this statement he adds a footnote, in which he cites a case of an entrepreneur's death by strangulation in Danzig in 1579. Since the accuracy of the source is unsure, Schumpeter adds: "*se non è vero è ben trovato*" ("if it is not true, it is well said").

Before leaving Schumpeter's account of resistance to entrepreneurship in *The Theory of Economic Development*, a bit more must be said about what exactly he means by the term resistance. It is true that Schumpeter presents us with some useful metaphors about the nature of resistance. At one point, for example, he says that "all knowledge and habit once acquired becomes as firmly rooted in ourselves as a railway embankment in the earth" (Schumpeter, 1934:84). And at another point he says that "carrying out a new plan and acting according to a

customary one are things as different as making a road and walking along it” (Schumpeter, 1934:85).

But even if these metaphors are suggestive, it is also clear that Schumpeter’s terminology about resistance is not very precise. No definition is given and different terms are used. Schumpeter uses, more precisely, terms that are typically held apart in today’s social science, such as “habit”, “custom”, “tradition”, “interest” and more. How to remedy this is something we shall return to later in this article.

### **Using the Concept of Combination as Theoretical Building Block**

So far, we have summarized Schumpeter’s argument in *The Theory of Economic Development*, with an emphasis on his two concepts of combination and resistance to innovation. The reason for singling out these two concepts, we argue, is that they constitute good building blocks for a theory of entrepreneurship that goes beyond the one that can be found in *The Theory of Economic Development*. With their help, in brief, one can take the theory of entrepreneurship, as first formulated by Schumpeter, to the next level.

Let us start with the concept of combination and Schumpeter’s typology of innovations. These were, to recall, “*a new good*”, “*a new method of production*”, “*a new market*”, “*a new source of supply of raw materials*”, and “*the carrying out of a new organization of any industry*”. Now, if instead of viewing these simply as different types of innovation, we instead view them as elements in the economic process, something interesting happens.

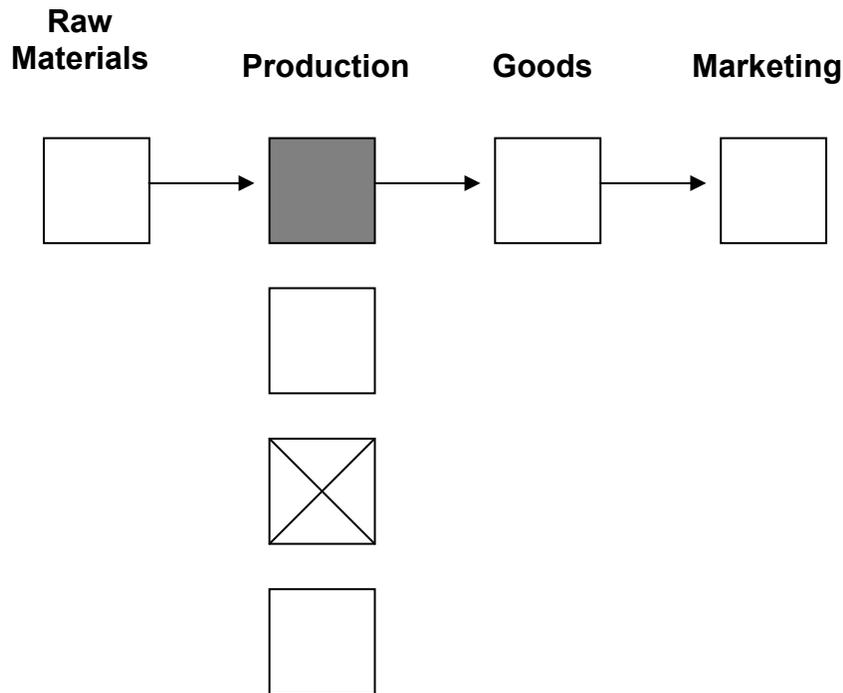
Together, the main types of innovation add up to *the whole economic process* - spanning raw materials, production, goods, and marketing - just as the formula of production-distribution-consumption. We recall that according to Schumpeter, the economy can be conceptualized as a “combination”, and that an innovation is “a new combination”; and we are now in a better position to see how these two uses of “combination” differ as well as are related. In speaking of *production as a combination*, there is a tendency in Schumpeter to include items that are needed for a good to come into being - more or less the whole economic process. In speaking of *an innovation as a combination*, on the other hand, Schumpeter tends to focus on one of the items that are needed for the production of the final good.

Nothing of course prevents two innovations from happening simultaneously – or even three or four. Schumpeter only mentions the case of one; and it is an empirical question if there can be more than one, how often this happens, and so on. Presumably it is less common with more than one innovation. But again, this is an empirical question.

So far we have kept close to Schumpeter’s use of the term combination, even if we have gone beyond it a bit when we argued that it covers the whole economic process rather than just the process of production. This way of looking at things, however, is useful in that it also allows us to view *an innovation* as consisting of a number of elements that combine into a whole.

If one proceeds in this way, one is in a position to develop a new way of conceptualizing a Schumpeterian innovation (Swedberg, 2009). This is to view an innovation as a process rather than as a single new element. The standard interpretation of a Schumpeterian innovation is as a new element – a new good, a new method of production and so on. The second way, which is implicit (and occasionally also explicit) in Schumpeter’s work, is that making an innovation means to push the whole process through: from conceptualizing the product, to producing it, to selling it.

If we take the example of a new good, say the mobile telephone, the traditional view would basically be to see the good itself as the innovation. The second way would be to see the whole process as the innovation - the whole laborious process of taking the mobile telephone all the way from conception to production to sale in the market (see Fig. 1).



**Figure 1. Schumpeter’s Typology of Innovations and His Two Ways of Conceptualizing an Innovation.**

Figure 1 illustrates how Schumpeter's way of reasoning suggests two different ways of conceptualizing an innovation. It can, first of all, be conceptualized as a new version of one single element in the economic process (as illustrated by the vertical line in the figure). This represents the conventional way of reading Schumpeter. But an innovation can also be conceptualized as a new version of the whole economic process that it takes to conceive, produce, market and sell some good (as illustrated by the horizontal line).

Schumpeter says that not only a whole economy but also an enterprise may be conceptualized as a combination (Schumpeter, 1934:14). This makes us think that a national or industrial economy may also be viewed as combinations. By looking at things in this way we get combinations within combinations, suggesting new ways of interpreting Schumpeter's idea that entrepreneurship and combinations are closely related.

This way of looking at things indicates why there are almost always unrealised innovations in the economy. A realistic view of what we may call the entrepreneurial matrix suggests a nesting of hundreds and thousands of subcomponents. Because of the combinatorial explosion, the space of possible innovations to be realised would very quickly grow to include more elements than the number of stars in the universe. The space of possibilities is truly enormous; and there is always hope for the entrepreneur. But since there is also the fact that new ideas are, on average, bad ones, most entrepreneurs will end up disappointed.

Schumpeter's combinatorial view of innovation may seem at odds with his emphasis on individualism. It was Schumpeter who coined the term methodological individualism, and he also advocated its use in economic theory (Schumpeter 1908). His celebration of the individual entrepreneur, especially in the first edition of *The Theory of Economic Development* (1911), is often criticized for being individualistic, psychological and for ignoring the role that teams play in the modern innovation process (e.g. Kanter, 1983).

But if one shifts the emphasis from the individual entrepreneur to the combination, one gets a new perspective on who the "entrepreneur" is. To see this, it is important to realize that an innovation encompasses a full combination, and not just the innovative element. The entrepreneur cannot, for example, locate a new source of raw materials, he or she must complete *all* the elements in the process: the production of a good, its marketing, and so on.

Holding off for a moment on the argument about Schumpeter's individualism, it is clear that at this point we also have to add *profit* to the combination that makes up the economic process. Why is that? The answer has to do with the fact that we are discussing entrepreneurship in a capitalist economy. Even if (say) a new source of raw materials has been located, the production of the good completed, and the good brought to the market – the whole operation

also has to yield a profit in order to be successfully completed or (to say the same) to constitute be a successful innovation.

This argument is implicit in Schumpeter's statement that "economic logic" must prevail. It is not explicit, but it has to be made explicit if the theory is to fit a capitalist economy. An innovation or entrepreneurship in a capitalist economy cannot be defined only as a new combination, but also by the need for the new combination to make a profit.

We now understand even better why Schumpeter argues that the entrepreneur has to be what he calls a "*man of action*" in the first edition of *The Theory of Economic Development* (1911).<sup>3</sup> We also understand why Schumpeter says that entrepreneurial ideas are easy to come by, while it is the carrying out of the whole entrepreneurial process from the beginning to the end that is difficult.

Within brackets it may be mentioned that some businessmen manage all the stages of the entrepreneurial combination except for the last one: to make a profit. Economic historian Torsten Gårdlund describes a few historical cases of this type in a study called *Geniuses of Failure (Misslyckandets genier; Gårdlund, 1934)*. Failure and success are closely related to one another in entrepreneurship, and in the cases discussed in this study, the failed entrepreneur often ends up blazing the trail for the successful one.

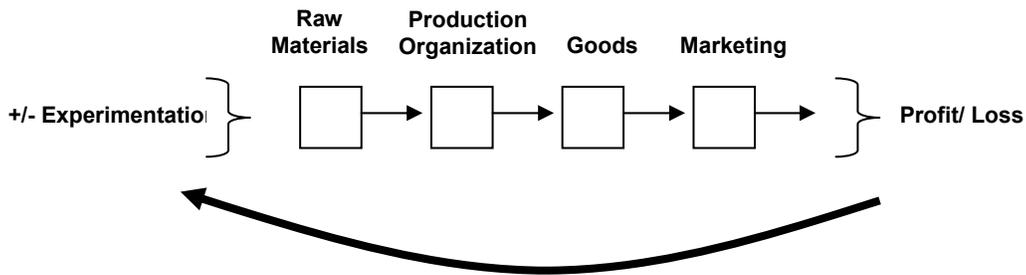
To look at the entrepreneurial process as a full process also makes it possible to sidestep Schumpeter's individualistic ideology of the entrepreneur as a superman, or the hero of the capitalist process. A requirement in any entrepreneurial process in a capitalist economy is that *all* of the stages of the economic process are carried out, and that there is a sizeable profit. But – and this is the point we want to make – it does not matter if the whole process is managed by one person, by several people, by an organization or even by several organizations (business units). What matters is that it *is* carried out, that it is directed from some central point - and that a profit is made.

An improved version of Schumpeter's notion of combination, inspired by his typology of innovations, would then be a combination that consists of *five* elements, with profit being the fifth element (see Fig. 2). Finally, in discussing Schumpeter's view of the economic process in this way, it needs to be pointed out that each of its basic units ("raw materials", "production", etc) are the product of a certain stage of economic development. Schumpeter's theory of entrepreneurship was clearly modelled on the industrial mode of production.<sup>4</sup> Combinations reflecting economies based on say the service sector would look different – but the logic of their analysis would remain the same.

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<sup>3</sup> *Mann der Tat*. The term is not used in the second edition or in the English translation from 1934.

<sup>4</sup> Schumpeter sometimes refers to the agricultural mode of production when he speaks of the circular flow type of economy.



**Figure 2. The Different Stages of Modern Innovations**

Figure 2 shows Schumpeter’s famous typology of innovations updated as to profits as well as the element of organization. Where Schumpeter only spoke of “the carrying out of a new organization of any industry” as an innovation, we assume that also the organization of the firm can constitute an innovation, closely related to production in a firm. The feedback from profit is a driver of experimentation. According to the behavioral hypothesis, experimentation increases with loss and decreases with profit.

### **Using the Concept of Resistance as a Theoretical Building Block**

Schumpeter’s concept of resistance to innovations can be further developed and theorized, as can his concept of innovation, and in this way they can become part of a new theory of entrepreneurship. While combination stands for the economic element of an integrated theory of entrepreneurship in the Schumpeterian model, resistance stands for the social or sociological element.

Schumpeter always presented his theory of entrepreneurship in the *Theory of Economic Development* as economic in nature and explicitly *not* as sociological. The reason why he did this has to do with his view that sociology is very different in its approach from economic theory. Sociology is holistic and not individualistic in its methodology; it focuses on “the social framework” of economic phenomena, as opposed to its “mechanisms” (which economic theory deals with; e.g. Schumpeter, 1934:60-1; [1949] 1951).

Nonetheless, one of the exciting parts about Schumpeter’s theory of entrepreneurship is precisely that it does have a sociological dimension, even if it is unacknowledged. Bringing the sociological part of Schumpeter’s theory into the open therefore represents an important task.

When this is done, one of the first things that strikes you is the vagueness of Schumpeter’s terminology when he speaks about resistance to entrepreneurship. As earlier mentioned, he uses terms such as “habit”, “custom”,

“tradition” and so on, but does not specify what differentiates them from each other or how they should be defined. This vagueness is presumably related to his failure to deal openly with sociological issues in *The Theory of Economic Development*.

One wonders, for example, about his failure to mention the role of *norms* in his discussion of resistance – a standard category in modern sociology. While it is true that the word “norm” was not commonly used when he published *The Theory of Economic Development* (1911, 1926, 1934), the idea itself was present. It can, for example, be found very early in the works of Durkheim and Sumner; it also holds a prominent place in Weber’s sociology (where it is called *convention* [*Konvention*]; Weber, 1978:34-6).

But there also exists another way of looking at Schumpeter’s profusion of categories in his discussion of resistance to entrepreneurship. We can regard it as an attempt to do justice to the great variety of social forces, social pressures and the like that exist in and around economic life. Schumpeter, to recall, looked at different types of resistance, and his instinct may also have led him right when he chose to use several concepts rather than one to depict resistance.

It is nonetheless the case that Schumpeter is imprecise in what we may term the sociological aspect of his theory of entrepreneurship. What one especially would have liked to find in his work is a discussion of exactly what constitutes the heart of the resistance to entrepreneurship. Since there is no such attempt, it is possible to complement Schumpeter and take his theory in a novel direction.

What terms, then, should one use to capture simultaneously what is going on in the everyday type of economy (circular flow) and the forces that create resistance to every new way of proceeding? One obvious candidate would be *norms*. A norm is usually defined as proscribed or expected behaviour, to which a sanction is attached. But one may also ask if this term is really the category that is best suited to capturing what is going on at the core of the modern capitalist economy, the modern firm and the like. One would, for example, expect to find a number of norms governing the way that employees interact with one another in various social settings, the way that certain items are kept outside of the market place, and so on. This, however, is not what we have in mind when we refer to the core of capitalism or, say, a firm’s activities, namely *production*: what to produce, how to produce it, and how to sell it, in order to make a profit.<sup>5</sup>

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<sup>5</sup> In discussing norms, a special mention should also be made of the term *convention* which, to recall, Weber uses in the sense of norm. The French School of Conventions uses this term in a different meaning, namely as collectively recognized references for the co-ordination of economic action (e.g. Swedberg, 2006, Jagd, 2007). H. Peyton Young, in contrast, defines convention as “a pattern of behavior that is customary, expected and self-enforcing” (Young, 1996:105). See in this context also the influential discussion of the concept of convention in David Lewis, (1969). Peyton

These activities are, for one thing, more interest-related than what normative behaviour typically is. It also seems wrong to describe the core activities of a modern capitalist economy or a modern firm mainly in terms of norms. The term “tradition” similarly seems wrong even if it may capture much of economic action in the distant past. And so does the term “habit”.

Max Weber uses the term “interest-driven behaviour” for a certain type of activities in modern society, including the market; and he defines these as “conduct [that] is instrumentally oriented toward identical expectations” (*interessenbedingt*; Weber, 1978:29). This seems a better candidate than, say, norms, because it directly acknowledges the role of interests and how these produce similar behavior. Weber also mentions that actors who try to break with interest-driven behaviour get punished by the other actors.

But Weber’s concept may well be too squarely focused on interest to be useful in this context; and one reason for this is that he uses interest as synonymous with self-interest. Core activities in a firm are indeed profit-oriented, but most of them are only oriented to profit in a distant or, better, in a mediated manner. This last quality is not part of Weber’s concept, which was especially designed to capture behaviour in the market, that is, actions that are directly oriented to prices (Weber, 1978:29).

In *An Evolutionary Theory of Economic Change* Nelson and Winter have suggested the term “routines” in this context; it has a number of interesting qualities (Nelson and Winter, 1982). It avoids, for example, the focus on profit and maximizing behaviour that is part of mainstream economic theory. There is also no clear sanction attached to it. And while routines include repetition, the term does not give associations to the distant past, as does tradition.

Another interesting quality to the concept of routines, as has been pointed out in recent research, is that it is situated at the collective level (Becker, 2008). Routines, in short, are not the result of individual level psychology along the lines of “habits” (cf. Camic, 1986). Most importantly, the concept of a routine plays the role of genes in Nelson and Winter’s evolutionary theory of the firm. They are stable components whose distribution can be altered in selection processes.

Despite significant advances in theories of economic evolution, the study of the combinatorics of routines is still in its infancy (Becker et al., 2006). For this reason we will suggest another and, to our mind, more flexible concept than routines.

The concept we will propose belongs to the same family as routines – but is more appropriate to the task at hand, namely to theorize entrepreneurship. As its definition by Nelson and Winter makes clear, the task of routines is primarily the opposite - namely to account for “what is *regular and predictable* about

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Young uses convention as part of his game-theoretical approach to innovations; in the French School of Conventions the idea of convention is used in an attempt to recast modern economics.

business behaviour” (Nelson and Winter, 1982:15).<sup>6</sup> Routines, in brief, are stable behavioral components that contain ready-made solutions to frequently occurring problems at the collective level.<sup>7</sup>

The concept we propose using is one that has its ancestry primarily in the work of Max Weber’s sociology, but which we will endow with a somewhat different meaning. This is *order* (*Ordnung*). Weber describes an order as a prescription for how to act, that is either “exemplary” or “obligatory” (Weber, 1978:311). To Weber, orders can exist at the micro level (say, in the form of conventions), at the meso level (say, in the form of organizations), and at the macro level (say, in the form of a legal order).

Our use of the concept of order will be limited to the area of the economy, since behaviour in the modern capitalistic economy differs in crucial ways from behaviour in the family, in politics, and so on. The main meaning of the term will be *a general prescription for how to realize a combination of economic activities so that profit will result*. To this we add that a prescription for how to act typically means that disorder will be eliminated and replaced by *order*. We use order, in other words, in two different but related ways. That something is in order, we suggest, has an inherent value, both for the individual (for psychological reasons) and for a firm or some collective unit (for the simple reason that disorder makes it hard to attain one’s goal).<sup>8</sup> Coordination to a goal typically demands order. But the realization of an order also results in a predictable profit from coordinated efforts. The deviation from order, in contrast, leads to uncertain outcomes.

One can find orders at the level of the firm, at the level of an industry, at the level of an economy and also elsewhere. While orders may be conceptualized as nesting inside one another, there also are ambiguities, frictions, contradictions and so on between different orders. At some level, routines enter as stable behavioral components of orders.

An order is, to repeat, a general prescription for how to act in the sphere of the economy, with the purpose of making a profit (“*ways of doing things*”, as Schumpeter puts it – e.g. Schumpeter, 1939:101). It is not as closely tied to specific details as “usage”, “habit” and “convention”. Instead it allows for variation of behaviour within the general framework of the prescription. An order is differentiated from a norm especially by its sanction, which is very specific:

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<sup>6</sup> It should be noted that in explaining economic change as an evolutionary process, Nelson and Winter also broadly include what Schumpeter would call entrepreneurship.

<sup>7</sup> Experimental psychology indicates that routines are repetition-induced dispositions promoting a shift from thought about intentions to an automatic mode where behaviours are reliably triggered by stable contextual cues provided by members of social groups (Knudsen, forthcoming). For a discussion of the role of emotions in Schumpeter’s theory of entrepreneurship, see more generally Goss, 2005.

<sup>8</sup> Order is of course also something that the state wants, for its own reasons, and with consequences that are beyond the scope of this paper.

loss or gain of profit. And as opposed to rules, an order has a natural boundary beyond which it is not applicable.

Variation also comes about in another way. Following Weber's conceptualization, we argue that the individual actor typically orients himself or herself to a specific order or, more precisely, to the perception that the actor has of the order. The individual may orient himself or herself to an order for different reasons – for the purpose of learning about it, to follow its prescriptions, to avoid these and more. By using the device of the individual actor orienting himself or herself to an order, it can be noted, one also avoids the overly deterministic perspective that comes with the notion of socialization.

It is important to include the notion of orientation in the concept of order for another reason as well. This is that economic theory by tradition works with an actor whose meaning has been assigned, while in economic sociology the meaning of the actor has been established empirically (Weber, 1978:Ch. 2). By including the concept of orientation in the analysis, the analyst has to take into account both the meaning of the order and the way the meaning that the actor invests his or her act with is oriented to the order.

Proceeding in this way opens up the analysis to empirical research as well as to a discussion of the concept of *meaning*. Both of these are crucial. While this article is theoretical, its aim is to produce a theory that is empirically testable. The concept of meaning is absolutely crucial to social science; and it should be emphasized that economic analysis has so far failed to do it justice. By forging a close link between entrepreneurship and meaning, the study of entrepreneurship is not only opened up to empirical research but also to some of the most important advances in modern thought, from Wittgenstein to analytical philosophy and the philosophy of language.

To sum up, a modern firm, an industry, or a whole economy can be seen as profit-generating entities that are made up of a number of different social elements. Social scientists currently lack the conceptual tools to properly sort out what is what in these entities beyond some rudimentary notion of institution. While it is clear that these elements to some extent can be conceptualized as norms, habits, and possibly also as traditions and customs, none of these concepts seems able to adequately express what guides the main economic activity in the modern capitalist economy, including the modern firms. The reason for this is simple enough: they were not constructed with this goal in mind, but to develop a general theory of society. This is in contrast to the concept we are suggesting: *order or a prescription for how to act in order to produce and to make a profit*. It has been designed for one purpose only: to facilitate the understanding of entrepreneurship.

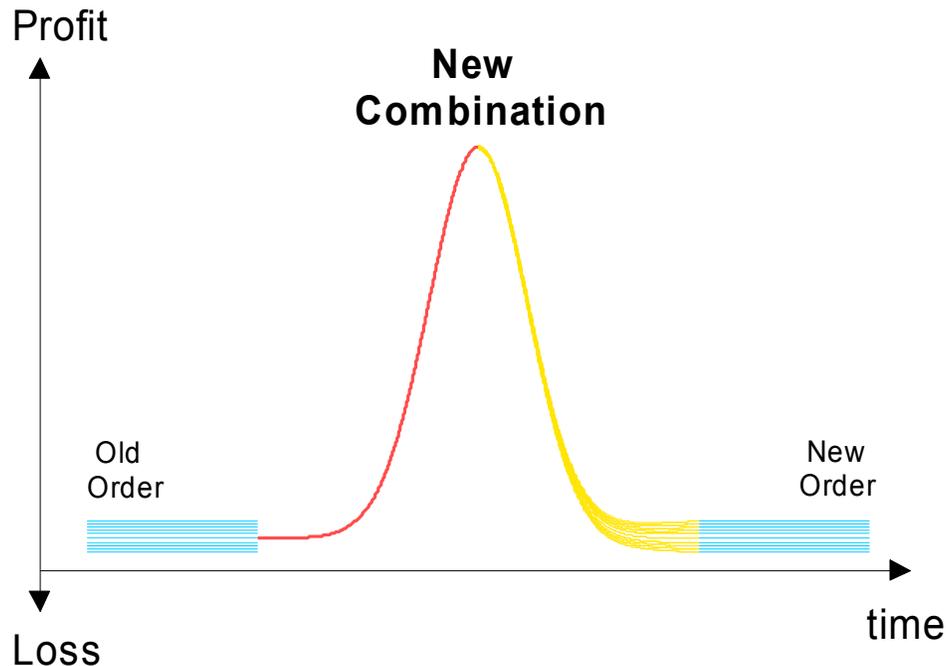
## **The Crucial Step: The Analytical Bringing Together of the Concepts of Combination and Order**

So far in this article we have discussed Schumpeter's theory of entrepreneurship and suggested ways of reconceptualizing two of its key concepts: *combination* and *resistance*. We have now come to the point where we will suggest a way to bring these two concepts together, and in this way produce a theory of capitalist entrepreneurship.

Recall that an economy can be conceived as a combination, and entrepreneurship as a new combination. But we have also suggested that an economy can be conceptualized as an order with an inbuilt resistance. A combination that makes up an economy usually takes the form of *an existing order*; and entrepreneurship represents a type of behaviour that breaks one of these orders up – but also sets off behaviour that will result in the creation of *a new order*.

The process involved can also be described as follows. An order exists in some part of the economy (or in a firm or an industry). An entrepreneur emerges and suggests a different way of doing things which, when successful, leads to high profit (entrepreneurial profit in Schumpeter's terminology). Other economic actors now begin to imitate the innovator, by switching over to the new way of doing things. This "competing down", as Schumpeter calls it, also leads to profit, although not as much profit as the original innovator (Schumpeter, 1939:291). The novel pattern spreads further, as more and more imitators appear and try to get into the game. At this stage *a new order* for how to do things in some area of the economy has begun to emerge.

Note that we have now brought together and integrated what is primarily the economic part of entrepreneurship (*combination/innovation*), with what is primarily its social part (*order/resistance*). Our theory predicts that profit will be the highest when a new combination successfully breaks with the old order, and that profit will fall as the new order gradually establishes itself. Fig. 3 summarizes the argument.



**Figure 3. Outline of a Theory of Capitalist Entrepreneurship**

As indicated in Figure 3, we suggest that an innovation can be conceptualized as the breaking up an old order, with rising profit as a result. High profits attract imitators, who eventually create a new order for how things are done in order to make a profit. In the new economic order as well as in the old economic order, there is competition and a low profit level. The two thickest lines represent industry averages of profit (in the old and the new order); the thinnest line the profit of the innovator; and the intermediately thick line represents the profit of the imitators.

Stepping back for a moment we are now in a position to suggest a definition of capitalist entrepreneurship: it is *the act of creating a new combination that ends one economic order and clears the way for a new one*. An economic order prescribes how to go about making a profit. The entrepreneur orients his/her/its behaviour in a negative way to the old order (to avoid how things are typically done) and eventually helps to establish a new order, to which the average actor will orient his/her/its economic behaviour. To repeat, the element of orientation to an order underscores the need for doing empirical research in the study of entrepreneurship as well as taking the meaning of the economic actors into account.

It is clear that our definition of entrepreneurship differs from many current definitions or ways of using the term (for useful overviews of research on entrepreneurship, see e.g. Acs and Audretsch, 2003; Casson, Yeung, Basu and

Wadeson, 2006). Starting a small business such as flower shop, for example, does not represent an entrepreneurial act from our perspective since there exist well established ways for how to do this and how to run this type of business. Nor does the notion of entrepreneurship as the founding of a new organization fit our definition. There are two reasons for this: this type of behaviour is not limited to the economy; and it includes routine behaviour.<sup>9</sup>

## Uses of the Theory of Capitalist Entrepreneurship

Our idea of combinations being essentially the same as orders, and old orders being broken up through entrepreneurship and in this way opening up the way for a new order, is quite flexible and can be elaborated on in a number of ways. We can, for example, expand it to include the phase of experimentation (“kissing frogs”) that typically precedes a successful major innovation.

When profit is low, as it tends to be in an established (and competitive) order, most actors are satisfied with the existing situation.<sup>10</sup> Furthermore, deviating from the order means anxiety and a high risk for economic loss. Some actors will nonetheless start experimenting with new ways of doing things in order to make more profit. Or they will be driven by hope, much as some people are given to playing the lottery.

Failure-induced experimentation exists even in an established competitive order. When actors fail to meet the existing performance targets, they usually increase the level of experimentation in order to find better ways of doing things (Simon, 1955, 1956; March and Simon, 1958; Nelson and Winter, 1982).<sup>11</sup> Targets are often portrayed as being located at the individual level, but there are good reasons to include collective level targets too. Envy, for example, is a powerful stimulus (Knudsen, 2008; Daun, 1989). Experimentation can be induced by fear of failure to meet collective standards as much as failure to meet personal targets.

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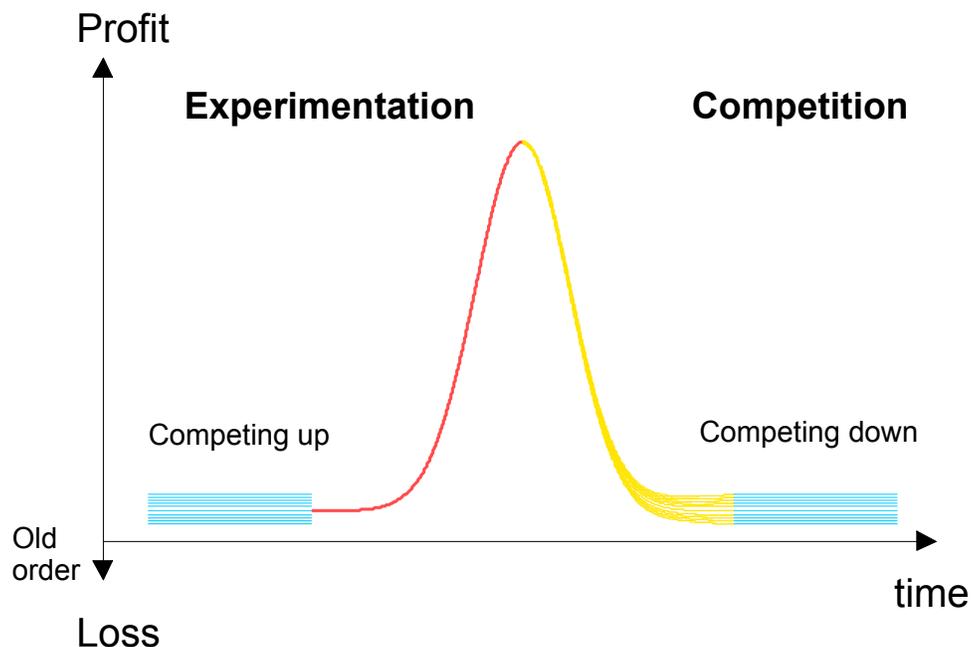
<sup>9</sup> Our definition of entrepreneurship as a way of creating a new order has some features in common with the Heidegger-inspired concept of entrepreneurship that philosopher Hubert Dreyfus and his collaborators present in *Disclosing New Worlds* (Spinosa, Flores and Dreyfus, 1997). Their main emphasis is on entrepreneurship as changing the ways in which things are done in the world – a position that comes close to our perspective. In contrast to our theory, however, this approach does not look at entrepreneurship in terms of breaking up an old economic order and setting off a process that leads to the establishment of a new one.

<sup>10</sup> Cf. the so-called Burke Theorem: “A way of seeing is also a way of not seeing – a focus on object A involves a neglect of object B” (Merton, 1987:8-9).

<sup>11</sup> Our theory of entrepreneurship has a certain affinity to the behavioral research program with links to Schumpeter’s economics and Weber’s sociology (Simon, 1955, March and Simon, 1958, Cyert and March, 1963, Nelson and Winter, 1982).

Some actors engage in small-scale incremental experimentation driven by imagined windfalls and this can (very occasionally) lead to surprising effects, in particular when the components of an order are interdependent. In this situation, small changes may lead to huge deviation in profits.<sup>12</sup>

As actors are rewarded for experimentation, more actors are likely to experiment for the same reason that lottery shops often announce a big winner. As more actors experiment and engage in what we suggest calling “*competing up*”, and do so more frequently, increasing disorder results. Actors explore different ways of doing things with high frequency. During such a period of disorder, one innovation may appear more promising than another because it has features that attract more customers (cf. the idea of dominant design in Murmann and Frenken, 2006). As one innovation replaces another in the process of competing up, profit may gradually rise till experimentation ceases and profit reaches its maximum. At this stage, there is typically only one actor left (see Fig. 4).<sup>13</sup>



**Figure 4. Elaborations on A Theory of Capitalist Entrepreneurship**

<sup>12</sup> When components of an order are interdependent, it is very hard to predict what will happen when components are changed. This point has been established within the NK model (Kauffman, 1993, Wright, 1931) and its application to organizational analysis (Levinthal, 1997; Knudsen and Levinthal, 2007).

<sup>13</sup> While it is clear that multiple *discoveries* exist (even if they by no means dominate), one may also ask if *multiple innovations* exist. Our guess is that they do and that their frequency is an empirical question.

Figure 4 expands on the basic relationship between profit and order in the theory of entrepreneurship in Fig. 3. At an early stage of the innovation process, several actors may get into the game (“*competing up*”). The number of actors decreases as the innovation takes its final shape – but goes up again as the profit of the innovator attracts an increasing number of actors. The temporary monopoly situation of the innovator is replaced by competition (“*competing down*”). - One can conceive of both the curve to the left and to the right of the peak as taking other forms than what is shown here, reflecting different roads from and to the new order.

Different types of actions during what may also be termed the experimental phase are also possible. One may, for example, imagine a situation in which an innovation, or “the new great thing”, as Schumpeter also calls it, has been implemented by a small firm (or by several small firms), which then try to market the item but are only moderately successful (Schumpeter, 1939:416). For the full profit potential to be reached, it may be necessary for a more experienced actor to intervene – such as a huge corporation that knows better how to mass produce and market the item in question.

At this point, there is a temporary monopoly – which will be broken up as soon as imitators appear; and by the time that a new pattern has been established for how to act (a new order), competition will have been re-established. Our theory not only addresses the issues of profit and order, but also that of competition.

Competition has two faces. In the experimental phase of *competing up*, there is competition among new combinations and its intensity and duration determines the maximum level of profits. This process is not unlike an epidemic spread of beliefs about the promise of experimentation (Becker et al., 2006; Watts, 2007). As individuals orient themselves to the economic order, they will notice when some entrepreneur concludes an experiment with profit and decide that they can do the same. Some individuals may also be so inspired by a single entrepreneurial success that they plunge into experimentation of their own. Others may require that a large number of entrepreneurs conclude their experiments with success in the form of profit. All of this may give rise to an unpredictable dynamic that will sometimes lead to an epidemic storm of experimentation and other times die away as ripples on the surface of the economic order.

In cases where there is a forceful wave of experimentation, the race among competing innovations will drive up the maximum level of profits to be attained. If experimentation quickly dies away, in contrast, it is very unlikely that there will be a very profitable innovation among the ones that are tested in the economy.

The state becomes important at this point, and not only for its general role of upholding order and providing business with a reliable and efficient legal

system. Even though higher profits will always inspire imitation, the temporary monopoly of the main innovator typically runs the risk of becoming a lasting monopoly (or a cartel, consisting of first and second generation innovators) unless the state intervenes. Competition, contrary to what libertarians believe, is typically not possible without forceful action by the state in the form of anti-monopoly legislation.

As imitators get into the game, a diffusion process starts in which a new actor - the consumers of the good – begins to play a role since it is they who decide how to utilize the item in question. In a number of cases it turns out that consumers have used the good in other ways than those for which it was intended. “*To adopt an innovation is to adapt it*” (Akrich, Callon and Latour, 2002:209; cf. Pinch and Oudshoorn, 2002, Hippel, 2005). This process is of interest to the entrepreneur in that it has an impact on the sales and the profit.

## **Capitalism and Entrepreneurship**

So far in this article we have referred to capitalism at two points. We have noted that Schumpeter’s two ideal types of circular flow and economic development both refer to the capitalist economy (and that capitalism does not automatically entail entrepreneurship, according to Schumpeter). We have also noted that a new combination per se does not constitute capitalist entrepreneurship; the combination also has to produce profit.

But our basic theory allows us to say more about the link between entrepreneurship and capitalism. The more entrepreneurial a capitalist economy is, to phrase it in Durkheimian terms, the more of its orders will be in a state of transition, with economic anomie as a result. Another consequence is that it will become more difficult for the state to act forcefully, which means that the laws and regulation of the economy will tend to play less of a rule in an entrepreneurial economy. The reason for this is that the state is so much forced to be reactive rather than active, that it is close to being perpetually off-balance.

Note that so far we have focused on the economic sphere in a narrow sense, with new economic orders replacing old orders. But the effects of the entrepreneurial process also have a tendency to spread beyond the economic sphere, into the spheres of the family, the political sphere and elsewhere in society. As people in old firms and industries become unemployed, for example, as a result of entrepreneurship, a number of social problems are created outside of the economy that local communities and the state are left to address.

While we question Schumpeter’s argument that entrepreneurship is the main cause of the business cycle, he was no doubt right that the more entrepreneurship there is, the more creative destruction there will be – with important effects at the macro level not only of the economy, but of society as a

whole.<sup>14</sup> Schumpeter speaks repeatedly in *Business Cycles* of “Economic Evolution”, a term that we find preferable to business cycles and which to our mind better captures the core of Schumpeter’s work on entrepreneurship (e.g. Schumpeter, 1939:86). This is especially the case, given Schumpeter’s view of capitalist evolution: “[capitalist] evolution is a disturbance of existing structures and more like a series of explosions than a gentle, though incessant, transformation” (Schumpeter, 1939:102). An argument can also be made for connecting up Schumpeter’s ideas to modern versions of evolution and in this way create an updated theory of capitalist evolution (Knudsen and Swedberg, forthcoming).

While *Business Cycles* is crucial for understanding the link between Schumpeter’s theory of entrepreneurship and capitalism, it is also possible to suggest some other relationships between entrepreneurship and capitalism, drawing on our theory of entrepreneurship as developed in this article. In the circular flow type of capitalism, repetition is the most common way to act, and repetition dulls the senses by creating habits, routines and so on. This means that the usual incentives in capitalism, such as profit and ownership, tend to be perceived as less important and, finally, perhaps, even as being of little consequence at all. The existence of a very strong welfare state could create a similar type of situation or add to it.

When people become indifferent to capitalism, they see little difference between this type of economic system and that of socialism. Socialism may even seem superior to capitalism since it would eliminate whatever is left of risk and disorder in society. In brief, we are in the same situation that Schumpeter discusses in *Capitalism, Socialism and Democracy* and other writings from the end of his life, namely a situation in which people are dulled into feeling ready for a peaceful transition to socialism. While Schumpeter was wrong in assuming that this might bring down capitalism, one can point to groups of people who react along these lines.

So far we have commented on a few connections that can be established between entrepreneurship and capitalism thanks to our theory of entrepreneurship. We have not, however, mentioned the main mechanism that unites the two. Starting from a definition of capitalism as the continuous accumulation of capital, we suggest that the main mechanism that links capitalism and entrepreneurship is *competition*.

What distinguishes capitalism from other economic systems is that it produces a profit, by trade through a market. Another feature that can only be found in capitalism is accumulation; and it is because of competition that part of the profit has to be reinvested. There are always competitors in capitalism as well

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<sup>14</sup> There are also important examples of the reverse effect; wars and other instances of creative social (and political) destruction have been great stimulants of creative economic destruction.

as the threat of extinction for the individual enterprise that does not keep up. The unintended consequence of competition and diverting some of the profit to reinvestment is, on the systems level, accumulation.

While competition brings about accumulation at a steady rate when economic orders are in place, the situation is different when there is entrepreneurship. Innovations brake up economic orders, change the nature of competition and, in doing so, affect the profit level. A capitalist economy with few innovations can be called traditional; one with many can be called dynamic.

## **Concluding Remarks**

At the outset of this article we argued that it was important to achieve an integration of economics and sociology in order to get a better understanding of entrepreneurship; and we have now suggested what such a theory may look like. Our theory confirms several of the intuitions of Schumpeter, especially his idea that entrepreneurship can be theorized with the help of the concepts of combination and resistance to innovation. Both of these concepts are flexible and open for further development, not only in the direction we have advocated here.

But there also exist drawbacks to Schumpeter's theory, which we have tried to overcome. Most importantly, Schumpeter stopped much too soon in his attempt to develop a theory of entrepreneurship. He especially did not work out the sociological part of his theory. And as to its economic part, he constructed a much too close link between entrepreneurship and the business cycle. His argument that (entrepreneurial) profit is zero in the circular flow is also artificial and of little help in a discussion of the level of profit in relation to entrepreneurship. Additionally, there is the fact that Schumpeter's use of the two ideal types of the circular flow and economic development tends to eliminate a discussion of the many additional forms of economies that exist somewhere in between these two extremes.

These drawbacks to Schumpeter's work, however, can be pushed to the side, leaving us with some excellent ideas about entrepreneurship with which to work. Our own attempt to recombine Schumpeter's ideas, so to speak, has led us to the theory of capitalist entrepreneurship, centered around the idea of the two sets of *orders* (old and new) that replace each other. This theory not only links economic theory and sociology directly to each other, it also has interesting implications for various problems that are related to entrepreneurship. Our main example of this has been what we call entrepreneurial experimentation, introducing the concept of "competing up", which complements that of "competing down". But one can imagine others as well. The making and unmaking of economic orders through entrepreneurship affects, for example, the way that we view the role of trust and risk-uncertainty in economic life; it also has

important implications for the way that we view the efficiency of state regulation. Finally, but not least, it is important to begin the empirical testing of the propositions that can be extracted from the theory of capitalist entrepreneurship.

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