Exploratory Note 2
Sources and Discovery of Entrepreneurial Opportunities – Innovative and Otherwise

INTRODUCTION

As we touched upon last week in context of our broader economic discussion, entrepreneurs seek out opportunities, materially innovative or otherwise, for profitable exploitation—whether by creating inefficiencies, eliminating them, some combination of the two, or via some other mechanism(s) entirely. In this first exploratory note of the evening, we delve further into the sources and discovery of entrepreneurial opportunities—drawing heavily on the ideas of Peter Drucker, widely viewed as the founder of management as a discipline, and Friedrich Hayek, a recipient of the Nobel Prize and certainly one of the most important economists of the twentieth century.

DRUCKER – THINKING ABOUT INNOVATION MORE BROADLY

Not all academicians require an innovative foundation for entrepreneurial activities; however, quite a few of them do by definition—and, perhaps, for good reason. As an example, consider Peter Drucker's stance on the matter as set forth in *Innovation and Entrepreneurship: Practice and Principle*s:

"*Entrepreneurs innovate* [emphasis my own]. Innovation is the specific instrument of entrepreneurship. It is the act that endows resources with a new capacity to create wealth. Innovation, indeed, creates a resource. There is no such thing as a "resource" until man finds use for something in nature and thus endows it with economic value. Until then, every plant is a weed and every mineral just another rock. Not much more than a century ago, neither mineral oil seeping out of the ground nor bauxite, the ore of aluminum, were resources. They were nuisances; both render the soil infertile. The penicillin mold was a pest, not a resource. Bacteriologists went to great lengths to protect their bacterial cultures against contamination by it. Then in the 1920s, a London doctor, Alexander Fleming, realized that this "pest" was exactly the bacterial killer bacteriologists had been looking for—and the penicillin mold became a valuable resource."

Now, this particular set of anecdotes—oil, aluminum, and penicillin—is certainly notable in historical (and present) impact, but represents only technological innovation. This is a narrow concept of innovation which excludes changes of the social or economic variety (termed social innovation). An example:

"The same holds just as true in the social and economic spheres. There is no greater resource in an economy than "purchasing power." But purchasing power is the creation of the innovating entrepreneur…[Consider that the] American farmer had virtually no purchasing power in the early nineteenth century; he therefore could not buy farm machinery. There were dozens of harvesting machines on the market, but however much he might have wanted them, the farmer could not pay for them. Then one of the many harvesting-machine inventors, Cyrus McCormick, invented installment buying. This enabled the farmer to pay for a harvesting machine out of his future earnings rather than out of past savings—and suddenly the farmer had "purchasing power" to buy farm equipment."

The idea of installment purchases, a social innovation, was materially transformational in this instance—as it has been in subsequent introductions to other markets. Now, thinking in economic terms, how does such an innovation impact supply and demand?

Consider a few other social innovations:

The Corporation –

Fractional Reserve Banking –

Invention –

Management –

The Assembly Line –

Within the context of such information, Drucker argues that the core business of entrepreneurs is the systematic pursuit of innovative opportunities.

Seven Sources of Innovative Opportunity

So, where are entrepreneurs to look for such opportunities? According to Drucker, there are seven—sometimes overlapping—sources. The first four are firm or industry specific: the unexpected, the incongruity, innovation based on process need, and changes in industry structure or market structure.

The Unexpected (Success, Failure, or Outside Event) –

The Incongruity (Reality - Positive versus Normative) –

Innovation Based on Process Need –

Changes in Industry or Market Structure –

The final three areas are outside the firm: demographics; changes in perception, mood, and meaning; and new knowledge.

Demographics –

Changes in Perception, Mood, and Meaning –

New Knowledge –

HAYEK – DISPERSED INFORMATION AND THE DISCOVERY OF ENTREPRENEURIAL OPPORTUNITIES

Friedrich Hayek's paper, "The Use of Knowledge in Society," has been selected as one of the best to ever be published in the *American Economic Review*. Before delving into it, a bit of background: Who was Hayek? For what work is he primarily known both within and without scholarly circles? Why does he remain such an important thinker when it comes to economics?

Now, we need to put "The Use of Knowledge in Society" into proper context. When was it written? What was the primary debate on the world stage when it comes to economics at that time?

When it comes to constructing a rational economic order, did Hayek support centralization or decentralization when it comes to prices? Why? Consider both scientific and day-to-day knowledge.

According to Hayek, how do market forces impact the allocation of scarce resources? Asked another way, how does the cascade effect between information changes and price adjustments work? Why is this so critical?

So, information exists in bit and pieces—not in easily identifiable wholes. What does this mean for entrepreneurship? If we are limited in the information available to us, can we perceive all entrepreneurial opportunities available to us?

CONCLUSION

Collectively, Drucker and Hayek provide a pretty solid foundation for the existence and discovery of entrepreneurial opportunities. But, is it really so simple? Keep an eye out for material changes within your sphere of unique knowledge and exploitable opportunities will inevitably avail themselves? Unfortunately, little in business seems to work this way. Just ask the professionals who analyze securities for a living. They have all kinds of analytical frameworks—and the overwhelming majority of them fail, on average, to beat the market on a risk-adjusted basis. And, to make matters worse, securities analysts do a lot better than entrepreneurs.