Comments on Entrepreneurship and Value Creation from an Individual and Environmental Perspective

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Introduction

Entrepreneurship and SME activity are generally viewed as contributing positively to economic development. In this context, the nature and extent of entrepreneurial value creation affects not only the sustainability and success of the venture, but also influences its wider contribution to the development of the economy. From a macro economic point of view, new ventures and SMEs contribute to economic development through innovating and creating employment, whilst at the business level value creation is commonly reflected in the expansion and growth of an enterprise. At the same time, for the individual entrepreneur a variety of sources of satisfaction needs to be considered, including non-pecuniary ones, since his/her assessment of 'value' may include a personal dimension.

In this context, a key question concerns the actions entrepreneurs take to create value, which brings us to the (internal and external) factors influencing the nature and extent of value creation for economies, enterprises and individuals. In an institutional economic theory viewpoint, drawing on North (1990), value creation in entrepreneurship is heavily influenced by the institutional settings, which are the 'formal' and 'informal' constraining and enabling forces for individual behaviour. There is a growing body of literature, which explicitly links entrepreneurship to the overall institutional frame (e.g., Audretsch et al. 2002; Karlsson, Acs 2002). Increasingly, studies are researching the influence of culture on entrepreneurship, comparing, for example, different country institutional profiles (e.g., Busenitz et al. 2000; Klandt, Brüning 2002; Wennekers et al. 2001), linking Hofstede's cultural dimensions to entrepreneurship (e.g., Audretsch et al. 2002), analysing single cultural factors such as post-materialism (e.g., Uhlaner et al. 2002) or researching the link between cultures and entrepreneurial cognitions (e.g., Busenitz, Lau 1996; Mitchell et al. 2000, 2002a).

Seen from an individual perspective, relevant theoretical concepts to analyse ways of value creation in terms of the actions entrepreneurs take include, for example, opportunity recognition (e.g., Eckhardt, Shane 2002; Shane 2003), heuristics in decision-making (e.g. Das, Teng 1999; Lyles, Thomas 1988; Schwenk 1984, 1988) and cognitions (e.g., Baron 1998, 2003; Mitchell et al. 2002, 2000; Simon et al. 1999). In this context, this paper sets out to explore how, and in which ways, individuals and environments influence value creation, aiming at integrating the two sets of influences.

The Role of the Individual in Creating Entrepreneurial Value

One stream of research, which can be used to analyse value creation in entrepreneurship from an individual perspective, concentrating on entrepreneurial actions, is connected to opportunity recognition. This relates to a broad range of cognitive factors, which influence the underlying process of opportunity recognition, i.e., discovering, recognising, and exploiting a business idea. Economists of the Austrian School have extensively researched the process of entrepreneurial discovery. For example, Kirzner (1979) argues that entrepreneurship is connected to the alertness an individual person displays towards opportunities, which exists independent of the entrepreneur. This draws attention to the cognitive properties of (potential) entrepreneurs, which have an impact on the forms of entry into entrepreneurship as well as subsequent development paths, thus indirectly influencing the extent and nature of entrepreneurial value creation. Here, Mitchell et al. (2000) distinguish between cognitions or mental maps related to resources needed to set up a venture (arrangement scripts), willingness and availability cognitions, which reflect the individual sensemaking of an entrepreneur (Weick, 1995).

Self-perceptions of entrepreneurs as reflected in the availability cognition (Mitchell et al. 2000), might restrict their possibility to recognise (the whole range of) business opportunities, thus constraining their ability to enter entrepreneurship or leading to less productive forms of entrepreneurial behaviour. This refers to self-imposed psychological barriers in those cases where entrepreneurs (wrongly) perceive that they may not have the possibilities and know-how to start or grow their own businesses, which for example has been shown for some entrepreneurs coming out of unemployment (Hinz, Jungbauer-Gans 1999), although the extent of the human capital involved is likely to be an influence here. Self-perceptions, ambitions, i.e., the willingness of entrepreneurs to choose among different possibilities in order to pursue an idea or to grow a business, and goals are closely linked to each other, as stated by Gatewood et al. (1995: 373): “How entrepreneurs think about themselves and their situation will influence their willingness to persist towards the achievement of their goal.” In this context, value creation might be closely linked to personal satisfaction, as studies indicate a broad variety of not only monetary, but also non-monetary goals in SMEs (e.g., Cromie et al. 1999; Kotey, Meredith 1997; Kuratko et al. 1998; Routamaa, Vesalainen 1987).

This leads to *proposition 1*: The nature and extent of entrepreneurial value creation indirectly depends on individual goals and self-perceptions of the entrepreneur with regards to the possibilities for venture creation and development, as those influence the steps entrepreneurs take to set up and/or expand their venture.

Through which mechanisms do entrepreneurs create value? This refers to the type of strategies that new and small firms employ. Research has shown entrepreneurs in new and small firms often improvise and ‘muddle-through’ (e.g., Baker et al. 2001; Covin, Slevin 1989; Welter 2003; Yan, Manolova 1998), with ‘strategy’ typically being emergent and ‘strategic vision’ more commonly demonstrated than strategic planning. (Gibb and Scott, 1985) Over time, decision-making processes tend to become increasingly routinised, as entrepreneurs fall back on behaviour they once have applied successfully, as long as they are facing familiar situations, for which ‘closed loop’ learning can provide the basis for making an adequate response. However, faced with less predictable, or unknowable change situations, tried and tested routines may be inadequate. An example could result from the implications of very rapid and substantial technological change on the appropriateness of current business models within a sector.

A routinised approach to decision making might limit the strategic options of entrepreneurs, as they undertake a ‘satisficing’ search. A number of empirical studies have linked the use of formalised planning to value creation in terms of enterprise performance, e.g., Lyles et al. (1993: 48): „...as small business owners adopt more formal planning processes, there is a significant increase in the thoroughness of their decision process, the breadth of strategic options emphasized in their business activity, and their overall performance as measured by growth in sales. Thus, small business owners may realize a competitive advantage through the use of formal planning procedures to enhance their strategic management process.” However, research results are not conclusive with regard to whether there is an impact of formal planning on the performance and success of small and new firms. Indeed, some authors go further and question the appropriateness of a formalised, strategic planning approach in small firms, where a combination of unknowable external environmental changes and limited internal resources makes a corporate approach to planning inappropriate. We therefore suggest setting aside the planning paradigm of mainstream management, and think more in broader terms of a structured versus an unstructured approach to doing business.

Here, cognitive biases inherent in decision making processes could re-enforce muddling-through and unstructured behaviour of entrepreneurs. The conflict theory of decision making explains this in terms of ‘avoidance’ (Lyles, Thomas 1988). Once an entrepreneur has settled on a particular course of action, she will only change her behaviour in cases where current actions lead to negative results, which are higher than the risk coupled with taking an unknown course of action. If new actions and options are considered as too risky and costly, entrepreneurs will not change their behaviour, hoping that “the problem will eventually go away.” (Lyles, Thomas 1988: 136)

This leads to *proposition 2*: The nature and extent of entrepreneurial value creation depends on the entrepreneur’s way of doing business. The creation of new value requires a degree of strategic awareness and vision, contributing to a structured way of doing business, even if this is not supported by an attempt at long term planning.

The Role of the Environment in Creating Entrepreneurial Value

The external environment is an important feature influencing entrepreneurial behaviour, as Knight (1997: 696) pointed out, saying that “we cannot assess the rationality of individual action without taking account of the institutional and cultural context in which everyday decisions are made.” In an institutional perspective, formal institutions provide the regulatory frame, thus creating opportunity fields for entrepreneurs, whilst informal institutions refer to implicitly codified attitudes which are embedded in a society, regulating individual behaviour.

Informal institutions, which legitimate entrepreneurship in a society, determine the collective and individual perceptions both of entrepreneurial opportunities and of what kind of behaviour is tolerated and used. Raiser (1997) distinguishes between conventions (i.e., societal solutions to collective choice problems), social norms which reflect one's desire to be accepted in society and where breaches are without consequences, and self-enforcing moral norms or values. In this context, informal institutions reflect the collective, tacit interpretation of individual mental perceptions (Denzau, North 1994). Informal institutions include cultural norms such as the value a society puts on entrepreneurship. Empirical studies such as the Global Entrepreneurship Monitor (GEM) indicate that this varies across countries, thus partly explaining differences in the extent of entrepreneurship. Other norms important for entrepreneurial value creation determine whether a society is consumer or savings-oriented and whether it tolerates profit-making behaviour. A society that does not tolerate profit making behaviour, restricts entrepreneurs in their ways of doing business (i.e., value-generating activities), in terms of productive entrepreneurial behaviour at least (Baumol, 1990). It could force entrepreneurs into the shadow economy, but on the other hand it could also foster social responsibility and non-profit oriented types of entrepreneurial behaviour (Welter et al. 2004).

As a result, we suggest expanding proposition 1 to read as follows. *Proposition 1a*: The nature and extent of entrepreneurial value creation depends on individual goals and self-perceptions of the entrepreneur with regards to possibilities for venture creation and development, as these influence the steps entrepreneurs take to set up and/or expand their venture. All are influenced by the normative environment, i.e., the values and conventions within a society.

There also is a role for the regulatory environment, which refers to the formal institutions, i.e., the constitutional, legal and organisational frame for individual actions. In environments where these institutions are weak or unstable, forms and patterns of unproductive or destructive entrepreneurship (Baumol 1990) might occur. At the individual firm level unproductive entrepreneurship may constrain the growth prospects of firms, in cases where the development of new markets is dependent on increased legal compliance and legitimacy. At the economy level, unproductive entrepreneurship may hamper the contribution of entrepreneurship to economic development.

For example, in early stage transition countries, where progress with market reforms has been slow or stalled (Smallbone, Welter 2001a), we can frequently observe behaviour that may be characterised as 'muddling through', but which often represents a learned response to a particular set of external environmental conditions. Moreover, nascent entrepreneurs in fragile environments, such as post Soviet countries, frequently turn to informal networking and social contacts in order to pursue their venture idea (e.g., Smallbone, Welter 2001b; Yan, Manolova 1998), which parallels a reliance on social capital at start-up in ethnic minority and/or immigrant communities (see Ram, Jones, 1998 for review). Whilst this is a resource needed for doing business and business success in early stages of venture creation, the same type of behaviour may be restricting in the long run (e.g. Rath, 2002). This applies to situations where entrepreneurs stick to a closed circle of business contacts. In such a context, this behaviour might restrict both their ability to create new value or expand the firm's existing value in terms of constraining the identification of suitable opportunities as well as accessing resources required to grow.

We also find examples of 'negative' entrepreneurial value creation in the sense of Baumol's destructive entrepreneurship. This refers to the so-called phenomenon of nomenclatura entrepreneurship, which evolved under transition in some Central and East European countries (Smallbone, Welter 2001b). Directors and managers of state-owned enterprises, as well as former politicians (the nomenclatura), frequently have used their 'parallel circuits' to privatise 'their' enterprises or to establish new businesses (Dallago 1997; Kusnezova 1999). Nomenclatura entrepreneurs originated from the Soviet 'Komsomol economy', where a number of business organisations were established within the youth organisation (Gustafson 1999). They were also involved in the 'spontaneous privatisation' that occurred in Hungary in 1988/89 (Frydman et al. 1998). Whilst this form of entrepreneurship need not have a destructive impact on entrepreneurial value creation per se, it contributed to a 'negative' value in those cases where enterprises were used for individual rent-seeking purposes, for example, having been dismantled immediately after purchase to realise personal profits.

This leads to *proposition 3*: The external regulatory environment influences the extent and the nature of value creation by new and small firms. In environments, where these institutional settings are new, and not clearly defined (emerging markets, new sectors, countries in transition), (nascent) entrepreneurs experience a higher uncertainty and ambiguity. This might both restrict their ability and possibilities to produce any new value on the firm level as well as result in 'negative' value creation on the macro economic level.

Combining the Individual and the Environment Perspective

As the previous sections illustrate, entrepreneurial value creation, understood as being a result of entrepreneurial actions, is influenced by both the individual and the environment. Consequently, value creation is a result of complex and recursive interactions between (nascent) entrepreneurs and the respective environment. This indicates that the concept of change or adjustment might be the 'missing piece' in linking both perspectives. Referring to the development of a longitudinal panel of SMEs over time in contrasting 'local' environments, Smallbone et al. (1999) refer to adjustment 'strategies', which in successful enterprises can involve recognising potential external threats and through adjustment converting them into opportunities.

From an external environmental standpoint, this refers to *institutional change* to be an important resource needed to initiate further value creation, particularly in uncertain and unstable contexts. Institutional change positively influences entrepreneurship when it removes or lowers barriers to market entry and market exit, thus creating opportunity fields for entrepreneurs, and vice versa. Examples of positive changes include the introduction of private property rights at the beginning of the transformation process in some former socialist countries, or efforts to review and improve the regulation of economic activity in mature market economies.

However, during periods of institutional change, we may also observe conflicts between formal and informal institutions. Whilst formal institutions may be easily modified and transformed, informal institutions such as codes of conduct and values appear to be more persistent, changing slowly (Williamson 2000). This implies that persistent informal institutions influence entrepreneurial behaviour in those situations where a new regulatory frame is introduced which no longer fits the prevailing business codes of conduct (Mummert 1999). In this context, conflicting formal and informal institutions encourage individuals to recur to a familiar course of action which as a rule reflect their previous experiences and tacit knowledge. This tends to reinforce 'trusted' and known codes of conduct, resulting at the individual level in an 'escalating commitment' of entrepreneurs to viable, but not necessarily the best courses of actions (Whyte 1986). From a macroeconomic point of view, these 'lock-in effects' may foster a sub-optimal resource allocation (Arthur 1994).

Thus, *proposition 4* reads: Institutional change can be favourable for value creation, as it opens up new fields which entrepreneurs can pursue, thus creating additional value. However, institutional change may not support value creation at the macro economic level, where it triggers and/or reinforces norm-deviant behaviour on the individual level. Conflicts within the institutional settings may encourage entrepreneurs to recur to familiar and known courses of actions, which were based on the requirements of the previous institutional environment. Although this behaviour might support firm performance and/or survival in the short run, it might be detrimental in the long run, restricting the ability of the firm to create and add entrepreneurial value.

This points towards the conclusion that in situations where formal and informal rules conflict, previous experiences and tacit knowledge are the main influences on entrepreneurial behaviour. This suggests that an important role for *behavioural change*, which brings us back to the individual perspective and the question of how to trigger behavioural change. Institutional economists understand changes in individual behaviour as a purely mechanistic response to changes in the institutional environment. In 'lock-in' situations, any changes in actions taken to generate entrepreneurial value would be a rational reaction to changes in the environment where entrepreneurs decide on the basis of cost-benefit calculations, albeit taking into account the institutional environment (Nee, Strang 1998). Seen from an individual, cognitive-based perspective, behavioural change is based on learning, which is reflected in changing 'theories-in-use' (Schön 1975), or the process of 'effectuation', as suggested by Sarasvathy (2001). However, learning itself is affected by the environment and/or access to resources.

Therefore, we suggest adding *proposition 5*: Fostering value creation in 'locked-in' situations, where institutional change is needed, requires entrepreneurial (re-)learning.

Institutional change itself could trigger entrepreneurial learning, but it is also needed for entrepreneurial learning to occur.

Conclusions

Whilst institutional economic theory draws attention to the institutional embeddedness and path dependence of entrepreneurial behaviour, which, as we propose, influences the extent and nature of value creation in entrepreneurship and SMEs, it has less to say about the roots of individual behaviour. North himself (1990: 140) identified this as one of the shortcomings: “We need to know much more about culturally derived norms of behavior and how they interact with formal rules”, particularly in order to analyse the influence of individual cognitive processes on the evolvement of informal institutions (Denzau, North 1994).

At first glance, the foundation of informal institutions, i.e., the ideologies (North 1981), resemble mental concepts such as individual cognitive maps containing experience-based interpretations of the environment. However, institutional economics is mainly interested in explaining the origin and emergence of informal institutions through collective processes, whilst reducing the role of ideologies to that of *shared* mental models of groups and societies. This is where an individual cognitive and learning-based perspective as reflected in the concepts touched upon in this paper, adds an important dynamic viewpoint to explaining entrepreneurial behaviour and thus also value creation in entrepreneurship.

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