ENTREPRENEURSHIP, INTRAPRENEURSHIP, AND THE LAW

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ABSTRACT

The legislative history of many small business preferences reveals that Congress’s objective was to encourage entrepreneurship, which is viewed as the nation’s core value and the gateway to a healthy economy. Nonetheless, over the years Congress has been delineating entities according to their size, rather than by entrepreneurial nature.

This article analyzes the taxonomy of entrepreneurship based on Joseph Schumpeter’s economic theory and posits that while most entrepreneurs may start small, not all small firms create new value. Quite the opposite, one may find at present valuable intrapreneurship developed in large and established firms. Instead, the article proposes a legal model of entrepreneurial orientation to replace references to size in the U.S. legal system.

The flexible and simple nature of the proposed model functions as an administrable indicator of firms’ potential ability to innovate in their marketplace. The progressive nature of the scale maintains equality by proposing to extend greater incentives to more entrepreneurial oriented firms. As opposed to the current one-factor size standard, the deployment of a multi-tiered, graduated composite indicator reduces the arbitrariness, complexity, and uncertainty currently inherent in the size-focused approach.

INTRODUCTION

“[E]ntrepreneurship, as defined, essentially consists in doing things that are not generally done in the ordinary course of business routine.”

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What drives economic change? There is no one clear answer.\(^2\) The sources of economic growth have been debated in academic literature since the beginning of Systematic Economic Analysis.\(^3\) Some scholars argue that policies which accelerate innovation or boost investment to raise capital intensity stimulate economic growth.\(^4\) Many agree that “entrepreneurship” is a vital component in economic stimulus.\(^5\) Since the 16\(^{th}\) century, prominent economists have recognized the essential role of entrepreneurship to the development of economy.\(^6\)

Throughout history, Western Economic Scholars have attempted to formulate the concept of “entrepreneurship”.\(^7\) In the three decades, there

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\(^5\) Amir Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 COMP. LAB. L. & POL’Y J. 817, 817 (2007) (“Underlying this trend is the belief that entrepreneurship is key for a number of desirable social outcomes, including economic growth, lower unemployment, and technological modernization.”).


\(^7\) Scholars have studied the proliferation of “entrepreneur” in American
has been a surge of national interest in Entrepreneurship Studies. What makes firms entrepreneurial? This paper aims to answer this question.

The concept of entrepreneurship no longer signifies the traditional notion of business innovation. Today, everyone is an entrepreneur. Recent scholars have further utilized the concept of entrepreneurship in fields other than Economic Entrepreneurship. For example, Political Entrepreneurship describes “the combination of political factors... and the achievement of political consequences.” The following are other modern variations of this concept: Social Entrepreneurship, the utilization of innovative methods to resolve civic problems; Policy Entrepreneurship, the advancement of new forms of legislation or government projects; Norm Entrepreneurship, the changing of social standards; and Moral Entrepreneurship, the influencing of society’s position on certain conducts. Entrepreneurship has become a catchphrase for everything that appears to be creative. While these etiologies of the new entrepreneurial catchphrases differ in their meanings, they share certain similarities.

Small business rhetoric is another example of the proliferation of "entrepreneurship". Seemingly the nation’s promise to a healthy academic idiom and concluded there are number of factors that explain the wide spread use of the term. See, e.g. David E. Pozen, We Are All Entrepreneurs Now, 43 WAKE FOREST L. REV. 283, 285 (2008).

8 ROBERT RONSTADT, ENTREPRENEURSHIP, TEXT, CASES AND NOTES, 1 (1984); Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, 1 (2011)("during the last twenty-five years, there has been a renaissance of interest in Schumpeter.")

9 David E. Pozen, We Are All Entrepreneurs Now, supra note 7, at 287-288.

10 Id. (“Martin Luther King, Jr., it turns out, was a social, policy, norm, and moral entrepreneur all at the same time.”)

11 Steven H. Hobbs, Toward a Theory of Law and Entrepreneurship, 26 CAP. U.L. REV. 241, 266 (1997). It was thought that in his 1911 essay on the view of the economy as a whole Schumpeter extended his theory of entrepreneurship from economics to human activities such as arts and politics. Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 2.

12 David E. Pozen, We Are All Entrepreneurs Now, supra note 7, at 287-288 (“In recent years, four main variants on the traditional concept of entrepreneurship have emerged: social entrepreneurship, policy entrepreneurship, norm entrepreneurship, and moral entrepreneurship. This Section provides a brief sketch of each term, in declining order of prominence.”)

13 Steven H. Hobbs, Toward a Theory of Law and Entrepreneurship, supra note 11, at 272.

14 David E. Pozen, We Are All Entrepreneurs Now, supra note 7, at 283.
economy, small business has been persistently endorsed in the name of entrepreneurship. Yet, many fail to distinguish between the two concepts and repeatedly identify small business owners as entrepreneurs.\(^{15}\) As opposed to the political rhetoric that emphasized the major role of small entities in reviving the economy, these traditional livelihood businesses exist mainly in order to provide means of support to the owner and his family. On the other hand, successful entrepreneurial entities take high risks by pursuing novel ideas, and when they are successful, result in rapid and substantial wealth creation.

The legislative history of small business preferences reveals that the intent to improve the conditions of these disadvantaged entities emerged from the desire to protect entrepreneurship and encourage risk-taking. However, instead of targeting entrepreneurial enterprises, Congress focused on demarcating entities according to their size.

In the last half decade, the world has been experiencing a global financial crisis that has resulted in an ongoing economic downturn. Some economists have predicted that this downturn wave will be followed by a period of “creative distribution” of the current economic order, which will bring with it an upward trend of economic welfare and prosperity.\(^{16}\) One has to hope that the government will help spur this moment by encouraging a distinct type of economic agents -- the entrepreneurs.

In order to do so, it is essential to recognize the conditions that favor and encourage novelty and business productivity, as well as, ways to lower the costs on entrepreneurial firms.\(^{17}\) The legal system is the primary apparatus in the hands of policymakers when dealing with such

\(^{15}\) See, e.g. “in any event, the key to bear in mind is that entrepreneurial small businesses are critical to our economy. Our laws are structured to foster the growth and development of the small business community. Any lawyer representing small businesses should be aware of government programs and policies designed to assist such clients.” Steven H. Hobbs, Toward a Theory of Law and Entrepreneurship, supra note 11, at 296.

\(^{16}\) Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 36 (“Since 2008 the global economy has been reeling from a devastating downturn. It is only to be hoped that this will be followed by a period of creative construction that leads the way to a new, prosperous economic order.”).

\(^{17}\) Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 37 (“But little is still understood about the conditions that will stimulate useful novelty. Social and economic policies should probably try to favor conditions that fall somewhere in between these two poles of either entirely suppressing or always endorsing novelty.”)
positive and negative externalities. Since law regulates markets, people, and firms, it has the effect of benefiting or harming the development of entrepreneurship, directly and indirectly. Consequently, it becomes imperative to accurately define these entrepreneurial entities, which are the vital element of economic growth.  

In my previous work, I criticized the path dependency of small business preferences inherent in the American legal system. I discussed how certain political institutions entrenched ineffective legal paths by sustaining dynamics of "increasing returns" through processes of "positive feedbacks" and "self-reinforcement" of small business preferences. The romantic ideal of small business as an economic and social catalyst has sprouted positive cultural feedbacks. As a result, our legal system is filled with small business benefits that contain contrasting notions of size in government Contracting Law, Labor and Employment Law, Patent Law, Securities Law, Health Law, and Tax Law. I concluded that many of today’s definitions of “small” are inconsistent, overinclusive, do not fulfill their legislative purpose, and create data distortions that reinforce the path dependency of small business preferences. They also result in the waste of revenues and the misallocation of government resources by focusing on size rather than securing a more efficient way to promote economic growth.

This article picks up where the others left off. It utilizes economic theories to create a legal model of identifying entrepreneurship. Entrepreneurship promotes various social and economic outcomes, such as stimulating economic growth, creating jobs, and supporting technological innovations. The government acts to promote entrepreneurship by both stimulating market competition and protecting intellectual property rights. Yet, over the years, instead of targeting entities that promote these goals, the government has chosen to focus on a flawed notion of smallness ultimate flawed standard that does not attest to a firm’s contribution to economic growth and innovation.

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This paper seeks to remedy this misconception. It does so by creating a conceptual legal model of entrepreneurship by introducing a multi-factor scale of a firm’s behavior that displays entrepreneurial qualities. This article proposes to replace current references in the law to “small business” (anywhere they seek to promote entrepreneurship) with this flexible graduated scale of entrepreneurial orientation. As opposed to the current one-factor size standard, this paper suggests the deployment of a multi-tiered schedule in the legal system to function as an indicator of firms’ potential ability to innovate in the marketplace.

The goal of this paper is to provide an alternative for some of the “small business” definitions in our legal system. Certain government programs that aim to promote entrepreneurship result in a waste of resources because they delineate potential entities by focusing on small business. A more efficient way to meet budgetary goals while promoting economic growth is to focus on promoting entrepreneurial ventures that have a higher likelihood of adding value to our economy.

The proposed model presents an alternative to the “smallness” category, which has the potential for improving both law in the books and law in action. First, the proposed scale defines the legal frontiers of entrepreneurial firms by injecting practical elements of economic entrepreneurship into the law itself. It aims to identify firms that promote novelty in various areas of the law. Second, the model provides the government with better tools to recognize and incentivize firms that are innovative and have the potential to improve the economy.

Accordingly, this proposal will better enable the government to account for differences among firms within the same market.

The paper proceeds as follows: Part II reviews the theoretical literature on entrepreneurship and focuses on developing an understanding of the defining characteristics of entrepreneurial ventures. Part IV develops a model for identifying entrepreneurial activity based on several elements of entrepreneurship such as longevity, innovation, employment expansion and growth, and offers a conceptual legal framework of displaying how law can be more effective in supporting

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22 98 IOWA L. REV. __ (2013) supra note 19, at __.
23 A Firm that improves the state of market competition is considered in antitrust law as a “maverick firm” described as one with “a greater economic incentive to deviate from the terms of coordination than do most of [its] rivals.” It does so by constraining the coordination of market dominator from becoming effective by, for example, refusing to take part in price increase. Generally, “[M]avericks are generally an afterthought in contemporary antitrust practice.” See, Jonathan B. Baker, Mavericks, Mergers, and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws, 77 N.Y.U.L. REV. 135, 140 (2002).
and fostering entrepreneurial activity. Part V briefly concludes by highlighting the complex dynamic between innovative entrepreneurship and the law.

II. EXPLORING THE THEORY OF ENTREPRENEURSHIP

The history of the term “entrepreneurship” reveals that it is an elusive concept that hasn’t developed a well-defined meaning. When reviewing the literature on entrepreneurship, one finds a vast number of economic, social, and other various models and approaches. This part of the article will outline the theoretical principles of economic entrepreneurship with an eye on developing a legal model of firm behavior that will be discussed in the next part.

The origin of the term entrepreneurship derives from the French word “entreprendre”, which denotes undertaking or embarking upon something. The word also has German origins. Renowned Austrian economist Joseph Schumpeter, one of the forefathers of the entrepreneurship concept, coined the word “unternehmen”, which

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24 Amir Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, supra note 5, at 819 (“A well-known problem in the study field of entrepreneurship is the lack of an agreed definition for this concept.”) (“As Kilby suggests, no one theorist has captured the elusive prey called entrepreneur in concrete terms. We have, however, attained a more comprehensive understanding of what entrepreneurial activity consists, and how such activity contributes to the functioning of society.”) Id.

25 Schumpeter criticized the scientists of the late 17th and 18th centuries for what he described as their superficial notion of the entrepreneur as the merchant, investor, or employer. See Joseph A. Schumpeter, *Entrepreneur* (1928) in *The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 239 (Scientists of the late 17th century developed a notion-completely superficial, but not inappropriate- of the entrepreneur…")


27 Markus C. Becker, Thorbjorn Knudsen, and Richard Swedberg *Introduction, The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 1 (2011) (“In 1984 an article entitled “The Age of Schumpeter” appeared in The American Economic review, and about the same time Peter Drucker wrote that “it is Schumpeter who will shape the thinking… on economic theory and economic policy for the rest of this century, if not for the next thirty of fifty years… It is, in brief, increasingly realized that Schumpeter’s way of analyzing the economy has much to contribute. His phrase ‘creative destruction’ has nearly become as popular as Adam Smith’s ‘invisible hand’ and
means the undertaker, and “unternehmergeist”, which translates to the "spirit of the undertaker." Later, Scottish and English economic philosophers such as Adam Smith, Jeremy Bentham, and John Stuart Mill introduced "entrepreneur" and "entrepreneurship" into the English language.

While the businessman became a proclaimed figure in economic discourse from the beginning of the 15th century, the notion of the entrepreneur began to flourish centuries later, among scholars such as Irish-French economist Richard Cantillon followed by French economist and businessman Jean-Baptiste Say. While Cantillon defined the term entrepreneur as “the agent who buys means of production at certain prices that are uncertain at the moment”, Say believed that an entrepreneur is “the agent who unites all means of production and who finds in the value of products…the re-establishment of the entire capital

Milton Friedman’s ‘there is no free lunch.’")

In the late 1920s Schumpeter focused his writing on entrepreneurship and published a series of four pieces, of which The Entrepreneur (1928) is regarded as the most high-profile one. See, Markus C. Becker, Thorbjorn Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 11.

See, ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, EDITED BY EDWARD CANNAN 53 (LONDON, 1904).


Schumpeter noted “it seems fair to say that J.B. Say only continued the French tradition by developing this analysis further. In this he was greatly helped by the fact that, knowing from experience what business practice really is, he really had a lively vision of the phenomenon which most of the other classic economists lacked.” See, Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 254. Schumpeter also criticized Say’s contribution to the theory of entrepreneurship describing it as “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. JOSPEH A. SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS, 555 (1954).

Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 254.
he employs, and the value of the wages, the interest and the rent which he pays, as well as the profits belonging to himself.”

Following Cantillon and Say, other theorists continued to develop the concept of entrepreneurship, distinguishing between business owners and business managers. Joseph Schumpeter established his famous theoretical schema of economic development as a dynamic process of change and is viewed as the greatest contributor to the theory of Entrepreneurship. As opposed to Adam Smith, Schumpeter argued that there is no invisible hand that directs the forces of the economy toward stability and growth. He believed that the circular flow of economic life evolves through a process of “Creative Destruction”, cycles of punctuated equilibria disrupted by sudden leaps of endogenous innovations. Schumpeter’s entrepreneurs are the destabilizing force, the principle agents of these changes in economy. They are avant-garde in

34 Jean-Baptiste Say, Catechism of Political Economy, 29 (1816).

35 Schumpeter’s most famous work within the theory of entrepreneurship was his Theory of Economic Development, which he published in German 1911. Even when Schumpeter published a revised edition in Germany in 1926 it did not drew much attention until it was translated into English under Schumpeter’s supervision and published in 1934.” See Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg, Introduction, The ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 4 (2011).

36 Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 254 (Schumpeter noted that Adam Smith “repeatedly talked about the employer-the master, the merchant and the undertaker- but the leading or directing activity as a distinctive function played a surprisingly small role in his analytic scheme of the economic process. His reader is bound to get an impression to the effect that this process runs by itself.”)

37 As opposed to passive adaptive behavior. See Joseph A. Schumpeter, The Theory of Economic Development (1911) in The ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 153-156.

38 In Capitalism, Socialism and Democracy Schumpeter describes the economic process as a long period of stability interrupted by shocks that are followed by a period of static economy. Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, The ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 18.

39 David E. Pozen, We Are All Entrepreneurs Now, supra note 7, at 290-291 note 29.

40 “What we observe is rather a behavior pattern, possibly supplemented by a scheme of motivation; a typical way of giving effect to the possibilities inherent in a given legal and social system both of which change in the process; the effects of entrepreneurial activity upon the industrial structure that exits at any moment; The consequent process of destruction and reconstruction that went on all the time.” Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 262. But see, Amir Licht, The Entrepreneurial Spirit and What the Law Can Do About It, supra note 5, at 822. (“In a continuing “circular flow of economic life,” the economy never reaches an equilibrium but rather shifts from one disequilibrium to another.”)
that they introduce new products, develop new methods of production, devise new business models, or create new combinations and new markets, creations that confront and eventually defeat previously-existing economic orders. Schumpeter’s entrepreneurs drive economic development with these innovations, which destroy the basis for the old economy while paving the way to a new economic order and result in periods of higher levels of prosperity and welfare.

The next part explores the elements of Schumpeter’s theory of entrepreneurship. Specifically, how entrepreneurship involves exploiting opportunities by taking entrepreneurial risks and starting for-profit ventures; it results in transforming markets and creating economic value and wealth.

A. New Combinations

According to Schumpeter, novelty is a central element, which distinguishes entrepreneurial activity from other business undertakings. In his essay, *The Analysis of Economic Change*, Schumpeter presents his view of the economic process and introduces the reader to this concept of New Combinations: the driving force that disturbs the market’s static state of equilibrium that exists at that time. The innovative aspect of entrepreneurial activity is vital to the economy, according to Schumpeter, because novelty and creativity challenge the current body of knowledge and premises and eventually promotes society by destroying old premises.

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42 Gordon S. Smith & Masako Ueda, Law & Entrepreneurship: Do Courts Matter?, 1 ENTREPREN. BUS. L. J. 353, 354-356 (2006)(“In Schumpeter's view, the entrepreneur is the agent of creative destruction, and the distinguishing attribute of entrepreneurial activity is novelty.”)

43 Joseph A. Schumpeter, The Theory of Economic Development (1934) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 50 (“Development in our sense is then defined by the carrying out of new combinations.”).


45 JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY, INTRODUCTION BY TOM BOTTOMORE, IX (HARPER ED, 1975) (“The development of the capitalist economy itself undermines the entrepreneurial or innovative function, which Schumpeter regards as the essential feature of capitalism, because technological progress and the bureaucratic administration of large enterprises tend to make innovation itself a routine matter and to substitute the
Production, in the economic sense, is the consolidation of different factors by combining “[raw] materials and forces within our reach.”

Innovation, as defined in accordance with the production process, means “to produce other things, or the same things by a different method” or “to combine certain materials and forces differently.” This can be achieved by setting up a new production function, integrating new production factors, or combining existing factors in a new way to lowers the production cost. Schumpeter summarizes five major ways that he considers to indicate the concept of innovation:

1. The production and carrying out of new products or new qualities of products;

2. The introduction of new production methods that are not yet tested by experience and can also exist in a new way of handling a commodity commercially.

activities of committees and teams of experts for individual initiative.”

Joseph A. Schumpeter, *The Theory of Economic Development* (1934) in *The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 49 (“to produce means to combine the things and forces within our reach. Every method of production signifies some such combination.”).

Joseph A. Schumpeter, *Business Cycles* (1939) in *The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 287 (“We will now define innovation more rigorously by means of the production function previously introduced. As we know, this function describes the way in which quantity of product varies if quantities of factors vary. If, instead of quantities of factors, we vary the form of the function, we have an innovation.”).

Id. (“We can define innovation also with reference to money cost. Total costs to individual firms must, in the absence of innovation and with constant prices of factors, monotonically increase in function of their output. Whenever at any time a given quantity of output costs less to produce than the same or a smaller quantity did cost or would have cost before, we may be sure, if prices of factor have not fallen, that there has been innovation somewhere… the old total or marginal cost curve is destroyed and a new one put in its place each time there is an innovation… innovation is the intrusion into the system of new production functions which incessantly shift existing cost curves.”).

Id. (“But this not only limits us, at first blush at least, to the case in which the innovation consists in producing the same kind of product that had been produced before by the same kind of means of production that had been used before… [we] define innovation as the setting up of a new production function. This covers the case of a new commodity, as well as those of a new form of organization such as a merger, of the opening up of new markets, and so on.”).

Joseph A. Schumpeter, *Business Cycles* (1939) in *The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 303 (“Let us visualize an entrepreneur who, in a perfectly competitive society, carries out an innovation which consists in producing a commodity already in common use at a total cost per unit lower than that of any existing firm because his new method uses a smaller amount of some or all factors per unit of product.”).
3. The creation of new forms of industrial organization;\textsuperscript{52}

4. The opening up of new markets;\textsuperscript{53}

5. The opening up of new sources of supply.\textsuperscript{54}

Schumpeter also clarified the deployment of production factors that happen to be unused\textsuperscript{55} or fulfilling existing demands is not what he considered “new combination”.\textsuperscript{56} Innovation, Schumpeter elucidates, is a self-determining decision to carry out new combinations by deploying the economic system’s existing supplies of productive means in a unique way.\textsuperscript{57}

Do all “new combinations” and innovations constitute Entrepreneurship and contribute to economic development? Schumpeter answers this question by distinguishing Innovation from invention or experimentation “which are quite another matter and do not themselves exert any influence on business life at all”.\textsuperscript{58} According to Schumpeter,

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  \item \textsuperscript{51} Joseph A. Schumpeter, \textit{The Theory of Economic Development} (1934) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 50.}
  \item \textsuperscript{52} Joseph A. Schumpeter, Entrepreneur (1928) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 245.}
  \item \textsuperscript{53} Id.
  \item \textsuperscript{54} Id.
  \item \textsuperscript{55} Joseph A. Schumpeter, \textit{The Theory of Economic Development} (1934) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 51 (“There are always unemployed workmen, unsold raw materials, unused productive capacity, and so forth. This certainly is a contributory circumstance, a favorable condition and even an incentive to the emergence of new combinations; but great unemployment is only the consequence of noneconomic events-as for example the World War-or precisely of the development which we are investigating….”)).
  \item \textsuperscript{56} Joseph A. Schumpeter, \textit{Business Cycles} (1939) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 290 (2011) (“it may seem strange to say that economies of scale internal to the individual firm, if they are to explain the shape of a cost curve, necessarily reduce to effects of lumpiness…. For if, for instance, a small tailor decides to employ a specialist in sewing on buttons because, and only because, his business expands, and if he would have taken that decision from the outset had his output been from the outset what it is now- if this is not then, to repeat, this decision spells innovation and nothing to do with negative inclination of cost curves.”)).
  \item \textsuperscript{57} Joseph A. Schumpeter, \textit{The theory of Economic Development} (1934) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 51 (2011) (“The carrying out of new combinations means, therefore, simply the different employment of the economic system’s existing supplies of productive means-which might provide a second definition of development in our sense. That rudiment of a pure economic theory of development…”)).
  \item \textsuperscript{58} Joseph A. Schumpeter \textit{The Analysis of Economic Change, reprinted}}
innovation differs from invention in that innovation consists of elements that are already available.\textsuperscript{59} Innovation and “economic leadership” (as Schumpeter often termed entrepreneurship) are more relevant to the economy than “invention” because unless inventions are successfully delivered to the market, they are economically insignificant.\textsuperscript{60}

Entrepreneurship, therefore, is necessarily linked to technological developments.\textsuperscript{61} The task of the entrepreneur is to carry the invention into practice. This is distinct from the undertaking of the inventor.\textsuperscript{62} While, in reality, most entrepreneurs are also inventors or financiers,\textsuperscript{63} Schumpeter concludes these actions to be insignificant in relation to their key function, which is generating innovation.\textsuperscript{64} The entrepreneur, he emphasizes, “is the man who gets things done and not necessarily the man who invents.”\textsuperscript{65} And “Enterprise” is the entrepreneurial conduit for implementing novel ideas and discoveries.\textsuperscript{66}

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\textsuperscript{60} Joseph A. Schumpeter, \textit{The Theory of Economic Development} (1934) in \textit{The Entrepreneur, Classic Texts by Joseph A. Schumpeter, supra} note 8, at 67. See also classic texts at 248 ("Economic leadership in particular must hence be distinguished from "invention." As long as they are not carried into practice, inventions are economically irrelevant. And to carry any improvement into effect is a task entirely different from the inventing of it, and a task, moreover, requiring entirely different kinds of aptitudes.")

\textsuperscript{61} Joseph A. Schumpeter, \textit{Economic Theory and Entrepreneurial History, supra} note 1, at 266 ("technological progress would be related to entrepreneurial action in a way that may not always be obvious but would be very important all the same.").

\textsuperscript{62} Id.

\textsuperscript{63} Id. at 266 ("as a matter of history, the entrepreneur is almost as often an inventor as he is a capitalist but it seems to me that analysis shows that neither of these capacities are essential to him.").

\textsuperscript{64} Joseph a. Schumpeter, \textit{The Theory of Economic Development} (1934) in \textit{The Entrepreneur, Classic Texts by Joseph A. Schumpeter, supra} note 8, at 67. See also classic texts at 248 ("Although entrepreneurs of course may be inventors just as they may be capitalists, they are inventors not by nature of their function but by coincidence and vice versa. Besides, the innovations which it is the function of entrepreneurs to carry out need not necessarily be any inventions at all. It is, therefore, not advisable, and it may be downright misleading, to stress the element of invention as much as many writers do.").

\textsuperscript{65} Joseph A, Schumpeter, \textit{Economic Theory and Entrepreneurial History, supra} note 1, at 266.

\textsuperscript{66} Joseph A. Schumpeter, \textit{Business Cycles} (1939) in \textit{The Entrepreneur, Classic Texts by Joseph A. Schumpeter, supra} note 8, at 300 ("For actions which consist in carrying out innovations we reserve the term Enterprise; the
But not every combination exemplifies entrepreneurship if it is done as a response to existing increase in demand in the market.\(^{67}\) If this proclivity is ultimately traceable to the effects of other innovations that have initiated earlier or elsewhere, Schumpeter does not consider the later combination to be novel.\(^{68}\) Innovation has to occur independently and create a demand in the market, rather than be driven by an increase in existing demand.\(^{69}\) Yet, tracing innovation to previously existing market demands is not an easy task, especially since innovations are not isolated, but tend to cluster as first some and then other firms follow in the wake of the successful innovation.\(^{70}\) And successful innovations also tend to expand to other related industries.\(^{71}\)

Therefore, many economic theorists that continued Schumpeter’s work, focused more closely on the concept of technological innovation. They maintained that innovation is the determinant that distinguishes between small livelihood businesses and entrepreneurial ventures.\(^{72}\) Subsequently, scholars labeled innovation as occurring when technologies and scientific developments yield new economic individuals who carry them out we call Entrepreneurs.”)\(^{67}\)

\(^{67}\) Id. at 293 (2011)(““Of course the reverse would not be true: not every new plant embodies an innovation; some are mere additions to the existing apparatus of an industry bearing either no relation to innovation or no other relation than is implied in their being built in response to an increase in demand ultimately traceable to the effects of innovations that have occurred elsewhere.”).\

\(^{68}\) Id. at 298 (“Considerations of this type entail the consequence that whenever a new production function has been set up successfully and the trade beholds the new thing done and its major problems solved, it becomes much easier for other people to do the same thing and even to improve upon it. In fact, they are driven to copying it if they can, and some people will do so forthwith.”).\

\(^{69}\) Id.\

\(^{70}\) Id. at 298 (“This seems to offer perfectly simple and realistic interpretations of two outstanding facts of observation: first, that innovations do not remain isolated events, and are not evenly distributed in time, but that on the contrary they tend to cluster, to come about in bunches, simply because first some, and then most, firms foil win the wake of successful innovation; second, that innovations are not at any time distributed over the whole economic system at random, but tend to concentrate in certain sectors and surroundings.”).\

\(^{71}\) Id. (“It should be observed that it becomes easier not only to do the same thing, but also to do similar things in similar lines-either subsidiary or competitive ones-while certain innovations, such as the steam engine, directly affect a wide variety of industries.”).\

opportunities. While innovation mostly occurs while creating new products, once those products are fully developed and the competition shifts to price, innovation can then be successful in reducing costs of and promoting existing products.

Lastly, innovation also takes place in low-tech industries that do not generate new products, such as the Service Industry. Scholars argue that innovative processes can manifest when creatively packaging and marketing a business concept using strategic planning, or creating designs of products or services. Innovation in service-based industries is important to note because here it creates economic value by enhancing the value of an existing product or service and may even create a need for customers that did not previously exist.

B. Economic Value through Entrepreneurial Profit

Entrepreneurship was described as a dynamic process of creating incremental wealth by individual entrepreneurs that innovate and take risks. It is a series of actions that creates economic value by pulling together a new combination, or a unique package of resources to exploit an opportunity. The end product or service that results from the entrepreneurial process may or may not be new or unique, but “value must somehow be infused by the entrepreneur by securing and allocating

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73 Viktor Mayer-Schonberger, The Law as Stimulus: The Role of Law in Fostering Innovative Entrepreneurship, 6 Inform. Society J. of L. & Poly. 153, 181 (2010) (“The entrepreneur, and driven by technological change. In this model, entrepreneurs change the world through technology. They are the driving force and the lead actors in entrepreneurship.”)


75 A more complex methodology for studying entrepreneurship is to consider it as an evolving process of innovation.” Steven H. Hobbs, Toward a Theory of Law and Entrepreneurship, supra note 11, at 278.

76 Id. at 277.

77 See, e.g. Thomas J. Peters & Robert H. Waterman, Jr., In Search of Excellence: Lessons from America’s Best-Run Companies 224 (1982) (describing innovations that were first created and then were revived through innovative use such as the Minnesota Mining and Manufacturing Company (3M) innovative reuse of existing products.)


79 Id. at 16.
the necessary skills and resources.\textsuperscript{80} This economic value is what Schumpeter termed “entrepreneurial profit”.

Schumpeter distinguishes between entrepreneurial profits and other business profits by emphasizing the scope and timing of their onset. Entrepreneurial profits, he argues, are the portion over and above a normal profit or monopoly profit. These profits follow innovation and do not arise from responding to a growing demand in the market. Instead, entrepreneurial profits initiate from a static situation and create a demand that attracts other imitators to fulfill that demand. The result of these profits is the creation of wealth and economic advancement. The accumulation of profits also facilitates economic and social mobility to the entrepreneur.\textsuperscript{81} Once the innovation trickles down to the local businesses in related industries, it increases nationwide prosperity.\textsuperscript{82}

Yet, entrepreneurial profit, Schumpeter explained, is only a temporary premium in successful innovation.\textsuperscript{83} It is temporary because as soon as competitors follow, that special premium transforms into common business profits\textsuperscript{84} Nonetheless, preceding the pressure of competition and prior to the entrance of additional market players, there is a moment Schumpeter describes as the height of the entrepreneurial process:

Competitors do, of course, follow suit. But before that happens, success brings unusual, perhaps even very large profits. To push through something new is the function of the entrepreneur. To fill this function represents the essence of the entrepreneur. The

\begin{footnotes}
\item[80] \textit{Id.} at 28.
\item[81] Joseph A. Schumpeter, \textit{Business Cycles} (1939) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra} note 8, at 304 (“It follows that the bulk of private fortunes is, in capitalist society, directly or indirectly the result of the process of which innovation is the "prime mover." Speculative maneuvers which are responsible for some, are evidently incidents to the process of economic evolution in our sense, and so are largely the unearned increments reaped by owners of natural resources-urban land, for instance-which account for others.”).
\item[82] Joseph A. Schumpeter, \textit{Economic Theory and Entrepreneurial History}, \textit{supra} note 1, at 258 (“We find that the great surplus gains are in general made in new industries or in industries that adopt a new method, and especially by the firms who are the first in the field.”).
\item[83] Joseph A. Schumpeter, \textit{The Entrepreneur in Today’s Economy} (1928) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra} note 8, at 272 (“Entrepreneurial profit is “a profit that in each individual case is temporary.”).
\item[84] Joseph A. Schumpeter, \textit{Business Cycles} (1939) in \textit{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra} note 8, at 303.
\end{footnotes}
profits linked to it are entrepreneurial profits properly speaking.

85 For a moment, when the entrepreneur achieves success in implementing the innovation, he has a monopoly position that provides him with entrepreneurial profits.86 And so, for only a short period of time until competitors follow, these entrepreneurial gains also constitute monopoly gains.87 They are temporary because no matter how much the entrepreneur struggles to preserve that stream of entrepreneurial profits by filing patent applications, imposing secrecy restrictions, or engaging in monopolistic strategies, in a competitive economy innovations are destined to diffuse to other market players, related industries, and the entire economy, resulting in the forfeiture of the entrepreneur’s monopolistic position.88

Schumpeter connected this idea of entrepreneurial profit to the concept of business cycles. He purported that an innovation that turns into a successful entrepreneurship results in profits that attract other businessmen who imitate the innovative idea. At that juncture, the economy starts to build an upward cycle. Yet, as more market players reproduce the initial entrepreneur’s success, speculations and overinvestment begin to drive down the level of profits, which brings the economy to a downturn.89

85 Joseph A. Schumpeter, The Entrepreneur in Today’s Economy (1928) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 270 ([entrepreneurial profit] “the premium put upon successful innovation in capitalist society and is temporary by nature: it will vanish in the subsequent process of competition and adaptation.”).

86 Id. at 268 (“Where an entrepreneur has a patent, or same resource’s that is inaccessible to others, etc., he has a monopoly position. As is well known, such a position can also be attained through merger or through privileges accorded by the state (a very important element in early capitalism). In such cases, the entrepreneur makes monopoly profit.”).

87 Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 260 (... [E]ntrepreneurial gain may also be called a monopoly gain, since it is due to the fact that competitors only follow at a distance…”).

88 Joseph A. Schumpeter, Business Cycles (1939) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 305 (“Such struggles for a share in profits that have been made are, however, less important for our subject than the struggles to conserve the stream of profit itself. Secrecy regarding processes, patents, judicious differentiation of products, advertising, and the like, occasionally also aggression directed against actual and would-be competitors, are instances of a familiar strategy, which in the public, as well as in the professional, mind have done much to veil the source and nature of profits in our sense, especially because that strategy may be resorted to in other cases as well.”).

89 Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER,
Today, Schumpeter’s ideas continue to have a large impact on economic literature and are developed by contemporary economists. For example, the Economist, publishes a column, entitled “Schumpeter” to highlight the importance of his economic theory as it relates to today’s business trends, finance, and management. Modern economists such as William Baumol, Israel Kirzner, and Nelson and Winter portray entrepreneurship as a depersonalized function and create formal modeling of innovation and economic evolution based on Schumpeter’s

90 supra note 8, at 5 (“A successful venture results in profit for the entrepreneur. The amount of profit attracts other businessmen, who imitate the successful innovation. As these new actors get into the game, the level of profit falls, and eventually there will be speculation and overinvestment. Since entrepreneurs, according to Schumpeter, come the introduction of new innovations first leads to a significant rise in the economy and then to a downturn. In this way Schumpeter connected his theory of entrepreneurship to the business cycle. In his giant work Business Cycles (two volumes, 1939)…”).  
91 Markus C. Becker, Thordbjon, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 2 (“Indeed, what Nathan Rosenberg said some years ago may still hold: ‘the study of technological innovation… consists of a series of footnotes upon Schumpeter’ (Rosenberg 1982, 106)”).  
92 See, http://www.economist.com/blogs/schumpeter. The blog has an illustration of a staircase with Schumpeter’s face for entrepreneurs to climb on before they jump off with their parachute into the sky. Markus C. Becker, Thordbjon, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 3 (“The Economists also has a blog entitled “Schumpeter’s notebook,” in which Schumpeter is used as inspiration to understand the individuals and ideas behind the latest trends in business and management. Schumpeter, in short, is definitely in the air today.”)  
95 See e.g., RICHARD R. NELSON AND SIDNEY G. WINTER, EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982); Richard R. Nelson and Sidney G. Winter, The Schumpeterian Tradeoff Revisited, 72 AM. ECON. REV. 32 (1982) (developing a theory of economic evolution that built on and expanded on Schumpeter’s most important ideas.)
The fertility of Schumpeter’s ideas is evident today, especially in the current economic downturn conditions.

C. Intrapreneurship

In Schumpeter’s later work, he emphasizes that entrepreneurs are not only self-employed or independent businessmen, but also employees of “big, particularly of ‘giant’ concerns, which often are but shells within which an ever-changing personnel may go from innovation to innovation.” This phenomenon is captured today with the term “Intrapreneurship”, which refers to divisions or employees that are responsible for developing “internal entrepreneurship” within large or established firms with market experience, exposure, and resources. By pioneering an initiative or subsidiary within the existing firm’s

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96 For example, HOWARD H. STEVENSON ET. AL., NEW BUSINESS VENTURES AND THE ENTREPRENEUR 16 (2d ed. 1985)(summarizing the entrepreneurship concept as “the process of creating value by pulling together a unique package of resources to exploit an opportunity.”). Nevertheless, some scholars criticized Schumpeter for gender preference as his entrepreneur has always been a male operating in a world of male culture. See, e.g. Stanley J. Metcalfe, Entrepreneurship: An Evolutionary Perspective, in MARC CASSON ET AL. THE OXFORD DICTIONARY OF ENTREPRENEURSHIP 59-90 (OXFORD UNIVERSITY PRESS, 2006).

97 Joseph A. Schumpeter, The Theory of Economic Development (1934) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 57 (“…in the first place we call entrepreneurs not only those "independent" businessmen in an exchange economy who are usually so designated, but all who actually fulfill the function by which we define the concept, even if they are, as is becoming the rule, "dependent" employees of a company, like managers, members of boards of directors, and so forth, or even if their actual power to perform the entrepreneurial function has any other foundations, such as the control of a majority of shares…it does not include all heads of firms or managers or industrialists who merely may operate an established business, but only those who actually perform that function.”).

98 Joseph A. Schumpeter, Business Cycles (1939) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 294.

99 This term was first coined by economists in the 1980s. See, e.g. Norman Macrae, Intrapreural Now, THE ECONOMIST, 67 (1982); See, generally Karina S. Christensen, Enabling Intrapreneurship: The Case of a Knowledge-Intensive Industrial Company, 8 EUR. J. INNOVATION MGMT. 305 (2005).

100 Up until the last decade, units that were divisions of large firms were excluded from the definition of entrepreneurs because it was difficult to establish their autonomy. Arshad M. Khan and V. Manopichetwattana, Innovative and Noninnovative Small Firms: Types and Characteristics, 35 MANAG. SCL. 597, 598 (1989), available at: http://www.jstor.org/stable/2632107.

structure, certain entrepreneurs-employees contribute to their firm’s entrepreneurial viability.¹⁰²

Schumpeter denoted Intrapreneurship in his work by cultivating the belief that established large firms are often more entrepreneurial and innovative than small firms.¹⁰³ He explains that the main reason for this observation is that big corporations have more resources to invest in innovation that attract and incentivize entrepreneurs-employees.¹⁰⁴ They are more devoted to innovation in their routine operation. They are also inclined to invest more daily resources in research and development in search of the next break-through innovation.¹⁰⁵ He illustrates this notion by referring to entrepreneurs-employees in big firms and even in government agencies:

The entrepreneurial function need not be embodied in a physical person and in particular in a single physical person. Every social environment has its own ways of filling the entrepreneurial function. For instance the practice of farmers in this country has been revolutionized again and again by the introduction of methods worked out in the Department of Agriculture and by the Department of Agriculture’s success in teaching these methods. In this case then it was the Department of Agriculture that acted as an entrepreneur… Again the entrepreneurial function may be and often is filled co-operatively. With the development of the largest-scale corporations this has evidently become of major importance: aptitudes that no single individual combines can thus be built into a corporate personality… in many cases,

¹⁰² Id. (“Scholarly interests in ‘Intrapreneurship’ are clustered around the issue of how to circumvent organizational inertia in established firms and to get novel things done, as opposed to conducting routine business.”)
¹⁰³ Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 18-19 ( “The famous “Schumpeterian hypothesis” that large firms are more innovative than small firms.”). This hypothesis that large firms are more innovative than small firms been criticized (e.g. Berchicci and Tucci 2006; vf. Hagedoorn 1996; Scherer 1986). THE ENTREPRENEUR, CLASSIC TEXTS 21 (2011).
¹⁰⁴ Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 18-19 ( “The argument is straightforward. Big firms have the means necessary to stimulate the entrepreneurial function in their employees. This follows from the shift in Schumpeter’s thinking associated with the depersonalization of the entrepreneurial function. If the entrepreneurial function is latent in most individuals, it becomes a matter of stimulating its expression. It is therefore obvious that the mature Schumpeter would consider how entrepreneurship could migrate from the market to the big corporations.”).
¹⁰⁵ Id.
therefore, it is difficult or even impossible to name an individual that acts as “the entrepreneur” in a concern. The leading people in particular, those who carry the titles of president or chairman of the board, may be mere coordinators or even figure-heads.106

Yet, if the entrepreneur-employee in large firms or government agencies most likely will not directly benefit from receiving an entrepreneurial profit, what is his drive to be innovative? Schumpeter answers this question with a glorified notion of entrepreneurs who enter this position by way of an employment contract and strive for professional recognition:

Although in this case, self-interest, in the sense of a connection between success and monetary profit, is not absent, it is an example of an intermediate form that is particularly interesting, precisely for this reason. Apart from the striving for sufficient income, it is mainly a case of orientation towards the ideal of good professional performance, towards the applause of the colleagues, the stakeholders, and the public, and towards personal reputation. These ideals, rather than entrepreneurial profit, are the decisive motives of behavior.107

Recent economists emphasize that entrepreneurship can also occur though groups with a few teams of entrepreneurs.108 These groups of entrepreneurs that together enable and constrain a firm’s innovation.109 Others continued Schumpeter’s intrapreneurship idea, demonstrating how groups in established firms produce entrepreneurs of higher quality than smaller firms110 Following Schumpeter, other scholars also display interest in innovation within formal or established organizations.111 Others found that midsized groups of people in big firms can also carry innovations.112 These scholars portray “corporate entrepreneurs” as “the

107 Joseph A. Schumpeter, The Entrepreneur (1928) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 249.
people who test the limits and create new possibilities for organizational action by pushing and directing the innovation process.”

Nevertheless, Schumpeter seemed to be dismayed by some of the practices in big corporations that, to his opinion, curbed the entrepreneurial character of the firm. One example is the appointment and hiring process of entrepreneurs-employees in big firms. Schumpeter claims that these processes are often political and not based on entrepreneurial merits. Similarly, the promotion and incentives practices of entrepreneurs-employees in big corporations, he states, are rather different than those in small firms.

Finally, Schumpeter argues that the everyday function of the entrepreneur in big firms is sometimes constrained by the firm’s bureaucratic structure. The essence of the entrepreneurial action, making decisions while assessing market conditions and taking risks, he says, is restricted by the presence of specialists who and departments that provide their findings, but also affect the entrepreneur’s thought process and key decisions. He concludes with discontent that the interests of the entrepreneur-employee and his firm are not aligned, noting:

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113 Id. at 210.
114 Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg, *Introduction*, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 12 (“The second argument turns on the role of the entrepreneur in the big corporation and the process by which he is selected. Whereas the entrepreneurs in small firms are selected according to how they fare in the competitive struggle, entrepreneurs in big corporations are selected according to criteria that resemble a political election or appointment (e.g. being an able speaker, a shrewd tactician, or a good compromise candidate).”).
115 Joseph A. Schumpeter, *The Entrepreneur in Today’s Economy* (1928) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 276 (“Rather, it can be more important to put the man at the top who can best deal with political parties, the public opinion and public administration.”).
116 Id. (“Instead they are chosen in a way that has much more in common with a political election or with appointment, sometimes even with an appointment following a ranked list. The characteristics that led to the leading position are no longer identical to those required to successfully fill out that position. Just like a good candidate does not need to be a good minister or a good head of state: often the canny secretary prospers, or the man who is popular in the decisive circles, the shrewd tactician, the able speaker.”).
117 Id. (“It follows that people in the trustified economy are promoted in different ways than in the competitive economy, and different people are promoted.”).
118 Id. at 274 (“In the large unit, in the trust organization, a phenomenon emerges that limits the importance of the entrepreneurial function, though it does not change its essence: the mechanization and bureaucratization of decision making….”) 118 Taking decisions in ever new situations is also the fundamental
The crucial point is that success of the man, and success of the enterprise, are not one and the same thing anymore. They are no longer different words for the same matter. In contrast, there is now an interest of the entrepreneur, which has to be distinguished from the interest of the enterprise.\textsuperscript{119}

In the next part, the paper will combine the main elements of Schumpeter’s entrepreneurship theory in a practical legal model to be applied in instances of the law where the legislature seeks to promote economic growth and entrepreneurship.

III. CREATING FLEXIBLE LEGAL SCALE OF ENTREPRENEURSHIP

Today’s policy-makers are fascinated by finding the determinants, effects, and spillovers of entrepreneurship with the hope of fostering economic growth. This part presents the normative aspect of the paper, offering legislators a legal model to measure entrepreneurial viability and implement in their decision-making. Since entrepreneurship has many dimensions, the identification of a single indicator that measures entrepreneurship may result in an arbitrary and skewed picture, and therefore is not the best course of action.

Instead, this legal model uses a scoreboard of economic entrepreneurial proclivity of for-profit firms by combining central indicators of firm-behavior amounting to an index of a firm’s entrepreneurial viability. It uses only fine main indicators for entrepreneurship due to the need to balance fairness and accuracy with simplicity and to allow entrepreneurs and policy makers to measure clearly and easily a firm’s entrepreneurial viability.

Yet, the boundaries of economic entrepreneurship are as wide as the ocean. Entrepreneurship may refer to small or large, private or public, domestic or international firms. It can involve moral or social, individual or collective characteristics, etc.\textsuperscript{120} In view of these issues, this proposal employs economic approaches in creating a legal model of capitalist entrepreneurship. It attempts to capture only the main and widely-accepted common features and measures of for-profit firms that are more likely to display entrepreneurial qualities. The article aims to balance its selection of variables based on methodical soundness, administrability, and measurability, as well as the overall relationship to the concept of function of today’s ‘captain of industry’, but such situations are increasingly offered to him…. Today, technical inventions are pressed upon him by his engineers, supported by detailed calculations. The ‘eye’, the gift of divination, is replaced by the calculation of the specialist. This turn of things is not only limited to the technical aspect of the matter.”).

\textsuperscript{119} Id. at 276.

\textsuperscript{120} Steven H. Hobbs, Toward a Theory of Law and Entrepreneurship, supra note 11, at 242.
entrepreneurship. Therefore, it is possible that, if examined separately, the chosen factors would not necessarily indicate entrepreneurial proclivity; it is the combination of these measures that provide an eclectic portrait of a firm’s inclination to be entrepreneurial.

In the last few decades, a vast amount of literature has been developing on individual characteristics of entrepreneurs, especially from the psychological perspective.\footnote{See, e.g. Amir Licht, The Entrepreneurial Spirit and What the Law Can Do About It, supra note 5, at 832 ("Entrepreneurs are indeed special individuals in that they tend to exhibit a particular combination of psychological attributes compatible with their role in the economy as new venture creators. Needless to say, this does not mean that all entrepreneurs exhibit these attributes equally strongly during their entire career…").} This scholarship portrayed entrepreneurs as special individuals who tend to exhibit a particular combination of psychological attributes that enables them to assume a role as innovators of the economy.\footnote{Schumpeter described the “typical entrepreneur” as more self-centered than other types, because he relies less than they do on tradition and connection and because his characteristic task-theoretically as well as historically-consists precisely in breaking up old, and creating new, tradition. Although this applies primarily to his economic action, it also extends to the moral, cultural, and social consequences of it. It is, of course, no mere coincidence that the period of the rise of the entrepreneur type also gave birth to Utilitarianism… Finally, there is the joy of creating, of getting things done, or simply of exercising one's energy and ingenuity. This is akin to a ubiquitous motive, but nowhere else does it stand out as an independent factor of behavior with anything like the clearness with which it obtrudes itself in our case."]. In the beginning of his writing, Schumpeter emphasized individual-level psychological factors to explain the behavior of the entrepreneur, but later moved to a social level explanation underlying collective level. Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 16.} Such scholars argued that entrepreneurs have a better ability to understand and evaluate certain risks and their returns.\footnote{Those studies found that entrepreneurs are usually able to identify opportunities due to their knowledge in a particular sector or industry, therefore perceive lower risks than others do. See, e.g. Viktor Mayer-Schonberger, The Law as Stimulus: The Role of Law in Fostering Innovative Entrepreneurship, supra note 76, FN 173 at 173.} Others explored the correlation between the information advantage and risk taking.\footnote{Viktor Mayer-Schonberger, The Law as Stimulus: The Role of Law in Fostering Innovative Entrepreneurship, supra note 76, at 170 (“[entrepreneurs] are somehow better than the average human… they are better able to evaluate risks and rewards.”)} Many factors, such as independence, confidence and resilience were found to affect the
entrepreneur’s decision to take risks and be innovative. Yet, to this day there is no agreement on the qualities that are essential for successful entrepreneurs.

While many studies concentrate on the core personality factors of entrepreneurs, this model does not consider individual entrepreneurs’ characteristics. Regardless, behind every entrepreneurial firm act individuals or groups of people with unique characteristics and entrepreneurial spirit. This paper will focus on the economic traits of entrepreneurial firms, because, in reality, it is not the character of people but their actions that matter.

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126 Carl P. Kaiser, *Entrepreneurship and Resource Allocation*, 16 E. ECON. J., 10 (1990) (“…prospective entrepreneurs will differ with respect to how much risk they are willing to bear, and with respect to how much utility they receive from undertaking "their own" projects. Accordingly, the rate or return required by an individual to undertake a given venture is determined by the individual's opportunity rate of return, the degree to which the individual prefers risk, and the degree to which the individual receives utility from the act of creating a new enterprise and exercising complete and absolute control over the venture.”)

127 Schumpeter acknowledged that individual entrepreneurs don’t usually remain entrepreneurial for long: “In particular an industrialist who creates an entirely new set-up will, in a typical case, then settle down to a merely administrating activity to which he confines himself more and more as he gets older.… This makes it difficult to deal with entrepreneurship… [there is a] necessity of considering business activity as a whole, the distinctive element and its modus operandi should not and need not be lost from sight.” Joseph A. Schumpeter, *Economic Theory and Entrepreneurial History*, supra note 1, at 259. It is argued that since 1926, Schumpeter himself shifted the emphasis from the individual entrepreneur (as portrayed in his 1911 essays) and his person to the entrepreneurial function. See, Markus C. Becker, Thorbjorn Knudsen, and Richard Swedberg *Introduction, The Entrepreneur, Classic Texts by Joseph A. Schumpeter*, supra note 8, at 8.

128 (“While various disciplines study issues relating to entrepreneurship, such as the characteristics of entrepreneurs or the performance of entrepreneurial firms, law and entrepreneurship studies should focus on the study of the optimal legal structures that facilitate the commercialization of entrepreneurial opportunities, as well as the regulation of entrepreneurial firms.”) Gordon S. Smith & Masako Ueda, *Law & Entrepreneurship: Do Courts Matter?*, supra
Accordingly, this model underlines the most common entrepreneurial firms’ behaviors. A firm-behavior model of entrepreneurship has a number of advantages over other models that focus on firms’ or individuals’ traits. First, the causal relationship between individual traits and entrepreneurial success has not been established. Second, entrepreneurial effectiveness manifests itself at a firm-level analysis and is measured in terms of firms’ performances. Third, while an individual entrepreneur’s behavior may affect an organization’s actions, the firm’s performance in the market is ultimately a result of organizational achievements.

Lastly, within the search of the traits of entrepreneurial firms, the model’s main objective is to remain a simple, administrable, and flexible model. The following sections will transform the main elements of the Schumpeterian theory of entrepreneurship to a simple and progressive legal model that identifies a firm’s proclivity to be entrepreneurial. The basic structure is presented in Figure 1. As in every normative framework, the measures depend on the nature of the policy objective. Here, the proposal seeks to create a simple, administrable, and flexible legal model of entrepreneurial orientation that can be employed by both legislators and entrepreneurs.

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129 Some studies even found that personality factors are not a key factor in predicting entrepreneurial success and are not correlated with innovation. See, e.g. A.M. Kahn, Entrepreneur Characteristics and the Prediction of New Venture Success, 14 OMEGA, 365 (1986); D. Miller and J. M. Toulouse, Chief Executive Personality and Corporate Strategy an Structure in Small Firms, 32 MANAGEMENT SCI., 1389 (1986).
A. Business Longevity

How does the prospect of entrepreneurship change with the longevity of a firm? Can a firm’s age attest to its entrepreneurial viability? The answer to these questions depends on other variables. In Schumpeter’s eyes, a new organization is another form of a new combination. Yet, when Schumpeter denoted “new organization[s],” he did not necessarily mean that all new firms are unavoidably innovative:

…we shall in general argue as if every innovation as now defined were embodied in New Firm founded for the purpose. There is obviously no lack of realism about this assumption.

Schumpeter did, however, acknowledge the fact that novel ideas are often, but not always, embodied in new firms, noting that “innovations still emerge primarily with the ‘young’ ones, and the ‘old’ ones display as a rule symptoms of what is euphemistically called conservatism.” Whether new firms are entrepreneurial is contingent upon, according to Schumpeter, their ability to convert these original ideas into success. Otherwise, he noted, these firms become obsolete and experience “a natural death”:

The one significant exception… [is] most new firms are founded with an idea and for a definite purpose. The life goes out of them when that idea or purpose has been fulfilled or has become obsolete or even if, without having become obsolete, it has ceased to be new. That is the fundamental reason why firms do not exist forever. Many of them are, of course, failures from the start….in the case of firms, is precisely their inability to keep up the pace in innovating which they themselves had been instrumental in setting in the time of their vigor… We visualize new production functions as intruding into the system through the action of new firms founded for the purpose, while the existing or “old” firms for a time work on as before, and then

130 See infra, part II.A.
131 Markus C. Becker, Thorbjorn, Knudsen, and Richard Swedberg Introduction, THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPERTER, supra note 8, at 50 ( “In the first place it is not essential to the matter-though it may happen-that the new combinations should be carried out by the same people who control the productive or commercial process which is to be displaced by the new. On the contrary, new combinations are, as a rule, embodied, as it were, in new firms which generally do not arise out of the old ones but start producing beside them…”).
132 Joseph A. Schumpeter, Business Cycles (1939) in THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPERTER, supra note 8, at 295. He added “On the whole, the exception seems, therefore, to reduce to modifications to be dealt with on the merits of each practical case.”
react with various characteristic lags and in various characteristic ways adaptively to the new state of things under the pressure of competition from downward.”

Therefore, Schumpeter envisioned the connection between firm age and its entrepreneurial character as a functional return. He suggested that innovation is frequently manifested by the creation of a new formal organization due to the instrumental role of the firm as a function for accruing entrepreneurial profit. It is more advantageous for the entrepreneur to establish a separate legal entity in order to facilitate the accounting of the entrepreneurial activity, to receive credit and finance the development of innovations, and to achieve legal autonomy.

Many scholars interpret Schumpeter’s “new organization” to denote the creation of a firm as a promising source of innovation. These scholars view the act of creating new ventures or new departments in existing firms as indicators of emergent entrepreneurship and novelty in the Schumpeterian sense. To them, too, the new organization serves

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133 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 293 (2011).

134 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 305 (“Profit, in our sense, is a functional return…but it would not always be safe to locate the entrepreneurial function according to the criterion of accrual. Weather it accrues to entrepreneurs or not is a matter of institutional pattern. It does so most completely in that form of organization which is characterized by the prevalence of the family firm.”).

135 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 234.

136 Yet, some scholars regard it as the organization of an industry such as formulating a cartel in a trustified economy, which was common when he constituted his theory. See, e.g. THE ENTREPRENEUR, CLASSIC TEXTS, 5 (2011) (“…one of the five major types of innovations is a new organization. What Schumpeter is referring to, however, is not a new type of firm but a new organization of an industry. One example of what he has in mind is the cartel.”).


138 See, e.g. Diego B. Avanzini, Designing Composite Entrepreneurship Indicators: An Application Using Consensus PCA, 3 (June 20, 2009) IN ENTREPRENEURSHIP AN ECONOMIC DEVELOPMENT: DESIGNING COMPOSITE ENTREPRENEURSHIP INDICATORS, Chapter 3 (Wim Naudé, ed., Palgrave MacMillan, 2011). Available at SSRN: http://ssrn.com/abstract=1988954 (“New entry is the act of launching a new venture, either by a start-up firm, through an existing …firm, or via "internal corporate venturing."’); See also, Gordon S. Smith & Masako Ueda, Law & Entrepreneurship: Do Courts Matter?, supra note 44, at 357 (“At the most general level, entrepreneurship is the creation of value through the creation of organization… the process of creating value operates through the creation of a multiperson system (organization) that transforms input such as materials, money, and time into output such as product
as a function through which entrepreneurs produce new combinations by successfully transforming resources into final goods. With the development of limited liability doctrines that became useful in protecting entrepreneurs from the risk of being personally liable for their entities’ defaults, forming new corporations or similar entities became an ordinary first step in the initiation of an entrepreneurial venture.

Recent studies on organizational demography support this assertion. For example, the New Entrepreneurship International (“GEM”) project is an initiative that surveys entrepreneurship indicators in over 80 nations in order to measure entrepreneurial activity across the globe and to explore the widely accepted link between entrepreneurship and economic development. One of the key indicators GEM is assessing is the business dynamics of firms and jobs. The project recounts early-state entrepreneurial activity by computing nascent entrepreneurship via setting up a business and considering the owner-manager of a new firm that is less than 3.5 years old.

The Kauffman Foundation, one of the world’s largest foundations devoted to entrepreneurship, was formed by philanthropist Ewing Marion Kauffman in the mid-1960s to foster “a society of economically independent individuals who are engaged citizens, contributing to the improvement of their communities.” Every year, the Kauffman Foundation releases the Kauffman Index of Entrepreneurial Activity, a leading indicator of new business creation in the United States.
study portrays new business creation dynamics – among other things – by industry, geography, race, age, and the founders’ education levels.\footnote{144} The Foundation reports that young firms – those five years old or younger – comprise about 35 percent of all firms, a decrease from nearly 50 percent in the early 1980s.\footnote{145}

If we follow the assumption that firms are established with a business idea and a profit-making purpose, then younger firms established afresh have a better chance to be entrepreneurial and harvest entrepreneurial profits,\footnote{146} rather than older firms that reached their full potential and exist solely on account of past success and the residues of market demands for their existing products. Evidently, this assumption, to some extent, ignores the phenomenon of intrapreneurship – established firms with employees or departments that continuously seek the next innovation and are entrepreneurial in their character.\footnote{147} This problem can be alleviated by incorporating a wider definition of new business longevity.\footnote{148} The problem is solved when the parent corporation establishes a new subsidiary to develop new discoveries and ideas, as is mostly the case today.

Moreover, not all new firms innovate. As Schumpeter noted, when the entrepreneur develops a successful idea, others firms follow and imitate this innovation. These followers enter the market to supply a geographical or competitive position created as the result of a growing unsatisfied demand for the products or services produced by the original entrepreneurial venture. While these firms may not necessarily be innovative, studies showed that they still contribute to economic growth.\footnote{149} Firm age, for that reason, is inadequate in predicting

\footnote{144} Id. The Kauffman Foundation, in collaboration with the U.S. Census Bureau’s Center for Economic Studies, also publishes the Business Dynamics Statistics, which is a data series on job creation and destruction by focusing on employer birth rate and the opening and closings of establishments.

\footnote{145} Haltiwanger, John, Ron Jarmin, and Javier Miranda. United States Census, Business Dynamics Statistics, Business Dynamics Statistics Briefing: Where Have All the Young Firms Gone? Figure 3, Declining Share of Activity from Young Firms (Firm Age Five or less) U.S. Private Sector, available at: https://www.census.gov/ces/pdf/BDS_StatBrief6_Young_Firms.pdf

\footnote{146} Discussed in supra Part III.E.

\footnote{147} Discussed in infra Part II.C.

\footnote{148} For example, a new business organization can be considered the formation of an independent entity; a new profit center within company which has other established businesses; a joint venture that is considered a new market entrants by its competitors or customers, etc. William B. Gartner, A Conceptual Framework for Describing the Phenomenon of New Venture Creation, 10 THE ACADEMY OF MANAGEMENT REV. 696, 698 (1985).

\footnote{149} BAUMOL, ENTREPRENEURSHIP: PRODUCTIVE, UNPRODUCTIVE AND
innovation, and entrepreneurship thus remains codependent on other factors to determine when firms are engaged in innovation or the duplication of existing ideas.\footnote{150}

Since firm age does not capture entrepreneurial character alone, it must necessarily be combined with other characteristics of firm behavior. While not a perfect predictor, many view a firm’s age as a stout indicator for the likelihood of entrepreneurship. Since the function of the entrepreneur is the formation of “an enterprise”\footnote{151}—that is, the process of transporting new ideas into success within this unit\footnote{152}—there remains a need to incorporate other factors that point toward firms engaged in this entrepreneurial process.

**B. Innovation Efforts**

Innovation generally refers to the making of superior products,\footnote{153} technologies,\footnote{154} or processes.\footnote{155} How do you measure innovation? The answer is not clear. Schumpeter’s innovations have been portrayed in the

\footnote{150}{For example, factors that will account for Schumpeter’s claim that intrapreneurship also produces more innovation. See, MARTIN RUEF, THE ENTREPRENEURIAL GROUP 171.}

\footnote{151}{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 241 (“Therefore, the true importance of the function of the entrepreneur consists, not in the mere running, but only in the creation of an enterprise…”); THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 306 (“…our assumption about New Firm carrying the new things into effect against resisting strata of old firms…”).}

\footnote{152}{THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 239 (“We further want to point to a second meaning of the term ‘enterprise’ in science, which from a linguistic point of view is the original one: Enterprise does not just refer to the unit of production, the shop, the firm itself. It also refers to the process by which this unit, this shop, the firm, emerges, the activity of certain economic subjects that create it. As we will see, only in that sense the entrepreneur the subject of the enterprise.”).}

\footnote{153}{David M Gann & Ammon J Salter, Innovation in project-based, service-enhanced firms: the construction of complex products and systems, 29 RESEARCH POLICY 955 (2000).}

\footnote{154}{Clayton M. Christensen, The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail, X (1997)(giving examples of established firms new processes such as Sears that was innovative at that time); Michael L. Tushman, Phillip C. Anderson, and Charles O’Reilly, Technology cycles, Innovation Streams, and Ambidextrous Organizations: Organization Renewal Through Innovation Streams and Strategic Change, in MICHAEL L. TUSHMAN AND PHILLIP C. ANDERSON, MANAGING STRATEGIC INNOVATION AND CHANGE, 3 (1997).}

\footnote{155}{THOMAS H. DAVENPORT, PROCESS INNOVATION: REENGINEERING WORK THROUGH INFORMATION TECHNOLOGY 3 (1993).}
form of 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.156 Yet, novelty in the manufacturing industry is different than innovation in the service industry.157 Innovation is usually associated with technological changes, but it may well occur in non-technological fields.158

There are numerous models of innovative firms.159 Yet, scholars are skeptical as to the existence of a method that can truly grasp every dimension of innovation.160 Economists developed the linear innovation model, which is initiated with investment in innovation and scientific knowledge and later develops into technological models and practical engineering.161 Other models describe how the outputs of early activities

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156 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 25 (“... [The firm] proved to be appropriate in technical accounting and absolutely necessary when credit was used to a considerable extent. Parallel to this development, there was the endeavor to achieve legal autonomy, for which purpose the law of the profit-making companies... was adapted and developed accordingly. The elaboration of these legal institutions, namely the stock company and the limited liability company, might have had great importance for the development of the enterprise, and in particular for the supply of capital.”).


158 KEITH SMITH, MEASURING INNOVATION in KEITH SMITH, JAN FAGERBERG, DAVID C. MOWERY, RICHARD R. NELSON, INNOVATION, 169 (2005) (“The challenge for those who would go beyond this is whether they can generate definitional concepts, survey instruments, and collection methodologies that make sense for other sectors or other aspects of innovation.”)


161 Rinaldo Evangelista, Tore Sandven, Giorgio Sirilli and Keith Smith, Measuring innovation in European industry, 5 INT. J. OF THE ECON. OF BUS., 311 (1998). Yet, this linear model has been criticized for placing over emphasis on R&D and ignoring non-R&D inputs to innovation in non-R&D industries. Other economic models such as the 'chain-linked model' of innovation, conceptualized
become the inputs of later processes. Investment in novelty is, then, the first stage in this model of innovation. For example, investment in innovation can be valued by observing the labor structure of a firm using the ratio of research technicians or equivalent staff members who participate in research and development (R&D) by performing scientific and technical tasks, and whose jobs require technical knowledge and experience in engineering or the physical and life sciences.

Since inputs are the raw materials of a system, a firm’s innovation inputs are people, information, ideas, equipment, facilities, specific requests, and the funds invested in R&D activities. One of the most common ways of measuring a firm’s innovation efforts is done by focusing on the cost of its innovation input, namely its business enterprise expenditure on R&D (BERD). For example, the Internal Revenue Code provides that, for the purpose of the R&D tax credit, qualified expenditures on R&D encompass expenditures paid for the performance of research in the pursuit of new scientific knowledge, counting labor and capital costs. These expenditures usually include the wages of employees engaged in performing, supervising, or supporting R&D; supplies, prototypes, testing materials, and any tangible property directly linked to R&D activities; payments for R&D

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163 This measure assumes that the more use there is of scientists and engineers the more likely that new technological innovations can be created and implemented Arshad M. Khan and V. Manopichetwattana, *Innovative and Noninnovative Small Firms: Types and Characteristics*, 35 MANAG. SCI., 597, 598 (1989), available at: http://www.jstor.org/stable/2632107. See, also Hage and Aiken, 1970.

164 See, e.g. The European Union, European Innovation Scoreboard. Yet, one of the main criticisms of these factors is their focus on R&D, whereas not all firms are R&D intensive. See, e.g. Rinaldo Evangelista, Tore Sandven, Giorgio Sirilli and Keith Smith, *Measuring innovation in European industry*, 5 INT. J. OF THE ECON. OF BUS., 311 (1998). “The fundamental limitations of these data sources are well known. R&D numbers measure only an input, which has no necessary relation to innovation outcomes. There are many examples of successful innovating companies and industries which perform relatively little R&D.” Rinaldo Evangelista, Tore Sandven, Giorgio Sirilli and Keith Smith, *Measuring innovation in European industry*, 5 INT. J. OF THE ECON. OF BUS., 311 (1998).


services performed under contracts with third parties; and basic research payments to non-profit organizations and institutions for performing fundamental research that focuses on evaluating theories and hypotheses.

However, some commentators have claimed that innovation encompasses more than research and development. Other innovative activities that go beyond the scope of R&D expenditures are, for example, other acquisitions of knowledge (such as patents, licenses, and technical services), the acquisition of machinery and equipment that incorporates new technology for standard use when producing a new product, other tools and staff training in preparation for the production of a new product, and so on. Therefore, a more accurate measure of innovation would consider a firm’s investment in innovation, taking into account those other activities. Nonetheless, for simplicity’s sake, this model will focus on the long-established indicator of R&D ratio that signifies a firm commitment to producing knowledge and new ideas, which, if successful, results in innovation output. Consequently, this paper uses the BERD ratio, measured as the ratio of R&D expenditures to total sales, also known as R&D intensity.

\[ \text{BERD ratio} = \frac{\text{R&D expenditures}}{\text{total sales}} \]

For example, in the service industry (finance, communications, transportation, and trade) firms create value and compete by buying products and designing a system or network, operating the system, or providing services for customers. See, e.g. Measuring Research and Development Expenditures in the U.S. Economy, at 56.

See infra, Part II.C.

Innovation effort in this paper is therefore calculated as average annual company-financed business-unit R&D expenditures over one year, expressed as a percentage of average annual business-unit sales. R&D intensity has been the most usable objective criterion to measure innovation.\(^{175}\) It has long been viewed in both popular and academic literature as a key determinant and indicator of the innovation progressiveness of firms, industries, and even nations. It is an indicator of a firm’s financial resources devoted to R&D, and also establishes the firm’s commitment to innovation.\(^{176}\)

**C. Innovation Productivity**

Innovation involves the combination of inputs in the creation of outputs.\(^{177}\) Innovation outcomes are the accomplishments of an innovative process that create value for an organization. The most common signal of innovation outcomes has been the successful application for legal protection of a firm’s intellectual products in the form of patents, copyrights, licenses, trademarks, service marks, product designs, trial production or publications, and so on.

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\(^{175}\) See, e.g., David B. Audretsch and Steven Klepper, *Innovation, Evolution of Industry and Economic Growth* (2000); See also, Richard Blundell; Rachel Griffith; John Van Reenen, *Market share, market value, and innovation in a Panel of British manufacturing firms* 66 REV. OF ECON. STUD. 529, 547 (1999)(using R&D expenditure as an input factor for innovation, and patent counts as an output factor for it); Otto Toivanen., P. Stoneman, and Derek L. Bosworth, *Innovation and market value of UK firms, 1989-1995*, 64 OXF. BUL. OF ECON. & STAT. 39, 41 (2002)(holding that R&D expenditures create intangible assets which is the same as ‘the storage of innovative knowledge’); The National Science Foundation differentiates between industrial basic research (pursuit of new knowledge that doesn’t have specific immediate commercial objectives), industrial applied research (investigation that might use findings of basic research toward discovering new scientific knowledge that has specific commercial objectives with respect to new products, services, processes, and methods), and industrial development research (the systematic use of the knowledge and understanding gained from research or practical experience directed toward the production or significant improvement of useful products, services, processes, or methods, including the design and development of useful products, materials, devices, and systems. See, Measuring Research and Development Expenditures in the U.S. Economy, at 56. For an analysis and criticism on the biases and quirks created by these categories see *Id.* at 57-58.


Many studies measured innovation yield as the number of patents, copyrights, and trademarks a firm introduced during five years as the firm’s ability to create new combinations.\textsuperscript{178} Other studies used bibliometric information, such as the number of scientific publications, books, research and grant proposals, presentations, cite counts in other publications, and so on.\textsuperscript{179} However, criticism exists regarding these studies’ focus on quantity and their failure to measure the quality of an innovation.\textsuperscript{180} A firm’s R&D department can be extremely productive when measured by the quantity of patents obtained, but can still fail to further the company’s business goals. Accordingly, an invention can be considered scientifically groundbreaking by outside evaluators and journal editorial boards but have little or no commercial value to the corporation.\textsuperscript{181} Simply measuring output is not enough; outcomes must also be measured by considering the real value the innovation added to the firm.\textsuperscript{182} An invention, as Schumpeter argued, is not enough to account for innovation.

Alternatively, innovation productivity is an indicator that incorporates the quality of the investment in R&D and the successful implementation of the innovation, which is, according to Schumpeter, the most important part of the entrepreneurial process.\textsuperscript{183} Although at times

\textsuperscript{180} Rinaldo Evangelista, Tore Sandven, Giorgio Sirilli and Keith Smith, \textit{Measuring innovation in European industry}, 5 \textit{INT. J. OF THE ECON. OF BUS.}, 311 (1998)(“Patent data is limited by variations in firms’ and industries’ propensity to patent; moreover it tells us only about the invention phase of the innovation process, and little about commercialization and hence the economic value or economic impact of an invention. Bibliometric data tells us much about the changing shape of fundamental research, but little about the innovation process.”).
\textsuperscript{181} For example, academic articles or cultural inventions can include innovations that advance our understanding of processes, certain behaviors but have no commercial value. See, e.g. Allan Hanson, \textit{The Making of the Maori: Culture Invention & its Logic}, 91 \textit{AM. ANTHROPOLOGIST} 890, 890 (1989).
difficult to measure, this indicator is frequently used to assess the effectiveness of a firm’s innovation efforts by determining the relationship between the commercial value of the innovation and the investments required to generate that added innovative value. Another goal is correlating a firm’s long-term growth and successful operations with its innovation productivity. Indeed, many companies now demand that their employees not only produce innovations, but also establish the value of these innovations to the organization.

Return on investment in R&D can be measured in several ways. The productivity of a firm’s innovation efforts has generally been estimated by comparing productivity growth or profitability in different firms with research expenditures or the growth of the research stock within these firms. However, the simplest way to calculate a firm’s...
innovation productivity is to consider its R&D spending as a percentage of R&D revenues, as the two are strongly correlated.\textsuperscript{190} R&D spending includes the costs of raw materials, salaries, information, equipment, the cost of facilities, and any funds needed for researching, developing, or testing innovative ideas.\textsuperscript{191} R&D revenues are the outputs directly derived from R&D investments and include any commercial value consummated from new patents, products, processes, publications, and so on.

Consequently, in this paper, innovation productivity is calculated as the present value of last five years’ cumulative R&D expenditures (R&D input) divided by the total present value of profits generated from these R&D investments in the last five years (R&D output).\textsuperscript{192} This ratio indicates the effectiveness of the investment in innovation by measuring the profits the firm directly derived from it.

\[
\text{Innovation Productivity (year } i \text{) } = \frac{\sum_{i=5}^{i} \text{PV(R&D input)}}{\sum_{i=5}^{i} \text{PV(R&D output)}}
\]

When an innovative idea is created, a firm may realize a high R&D productivity ratio to signify a higher R&D investment in the early stages of development, but once the investment is successfully developed into the innovation product, the firm starts to reap more entrepreneurial profits (denominator), and its innovation productivity ratio decreases. As more competitors enter the market, R&D profits decrease and the innovation productivity ratio increases.

In light of the recent economic downturn and challenges faced by


\textsuperscript{190} See, e.g. Ariel Pakes & Zvi Griliches, \textit{Patents and R&D at The Firm Level: A First Look}, NBER Working Paper No. 561, 1 (1980), available at: \url{http://www.nber.org/papers/w0561.pdf?new_window=1} (proving there is a statistically significant relationship between a firm’s R&D expenditures (input) and the number of patents it applied for and receives (output).)


firms across industries, improving R&D productivity is one of the important measures firms can take to improve profit prospects. Measuring the productivity of R&D investments is also important in motivating and rewarding workers and in assessing the contribution of R&D to the company’s business.

D. Employment Expansion

Schumpeter described entrepreneurship as creating wealth by combining factors such as labor and capital. Creating new organizations or operating within existing entities is one way of gathering resources in one place. Investing in R&D is another important factor toward executing an innovative idea. Nevertheless, there is often a need to include human labor in the equation. Investment in human capital is what makes entrepreneurial ventures the greatest contributors to employment expansion. And entrepreneurial firms have, therefore, been depicted as the biggest contributor to the nation’s employment growth.

Schumpeter portrayed the entrepreneur as the middleman between workers and capitalists. Accordingly, once an entrepreneur’s innovation is successfully implemented, their firm initiates mass production of its products by expanding and growing its workforce, and by creating value for the shareholders who provided investment capital. Seeing this process, it is no surprise that entrepreneurial firms are sought for the generation of economic development via employment growth.

Today there is a variety of approaches for calculating employment growth. For example, many studies measure economic development by the growth in the number of jobs per enterprise during five years of operations. These studies use absolute and relative changes in growth

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193 See, e.g. Steven M. Paul, Daniel S. Mytelka, Christopher T. Dunwiddie, Charles C. Persinger, Bernard H. Munos, Stacy R. Lindborg and Aaron L. Schacht, How to improve R&D productivity: the pharmaceutical industry’s grand challenge, 9 Nature Reviews 203, 204 (2010) (“The environmental factors that are reducing the industry’s profitability can only be mitigated by substantially and sustainably increasing the number and quality of innovative, as well as cost-effective, new medicines; but only if accomplished at reasonable R&D costs.”).


195 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 241.


197 See, e.g., Organization for Economic Co-operation and Development,
to overcome the small enterprise bias inherent when measuring enterprise growth rates.\textsuperscript{198} A different measure used by U.S. statistical agencies determines growth by calculating a second-order approximation of rates measured in logs.\textsuperscript{199} Other studies do not consider employee turnover over a certain period, but measure only the population of active enterprises reaching a certain employee threshold.\textsuperscript{200}

Here, for the sake of simplicity, the proposed legal model measures employment growth by dividing a firm’s net increase in the number of full-time employees between years $i$ and $i-5$ (the first year of operation for new firms), divided by the firm’s number of full-time employees in year $i-5$.\textsuperscript{201} In order to mitigate the growth biases of very small firms, the model includes only enterprises above the threshold of five or more employees.\textsuperscript{202}

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\textsuperscript{198} See, e.g. Birch Job creation in America: How our smallest companies put the most people to work, by David Birch. New York, NY: The Free Press, 1987. 244 pp. (this study measured employment growth as $(X_{t1} - X_{t0})X_{t1}/X_{t0}$).

\textsuperscript{199} See, Steven J. Davis, John C. Haltiwanger, Scott Schuh, Job creation and destruction (2001)(the authors calculated employment growth as $(X_{t1} - X_{t0})/(X_{t1} + X_{t0})/2$). See also, Steven J. Davis, John C. Haltiwanger, Gross Job Creation, Gross Job Destruction, and Employment Reallocation, National Bureau of Economic Research Working Paper no. 3728 6 (June 1991), available at: http://www.nber.org/papers/w3728.pdf; Steven J. Davis, John Haltiwanger, and Scott Schuh, Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts, 8 SMALL BUS. ECON., 297, 297 (1996)(holding that the conventional wisdom about the job-creating prowess of small businesses rests on misleading interpretations of the data.).


\textsuperscript{201} This model has been used in various studies. See, e.g. Erik Brouwer, Alfred Kleinknecht, and Jeroen O.N. Reijnen, Employment Growth and Innovation At the Firm Level, 3 J. EVOL. ECON. 153, 154 (1993)(measuring annual growth rate of employment slightly different by using fifth root of the increase in employment: $[\text{EMP}_{t1}/\text{EMP}_{t0}]^{1/5} - 1$). See also, Zoltan J. Acs and Catherine Armington, Employment Growth and Entrepreneurial Activity in Cities, 38 REGIONAL STUDIES 911. 921 (2004)(measuring average annual employment growth rate in year $\text{ems}_{t+1}$ as $(\text{empl}_{t+1}/\text{empl}_{t})^{1/3} - 1$).

\textsuperscript{202} See, e.g., Organization for Economic Co-operation and Development, Eurostat-OECD Manual on Business Demography Statistics, 61 (2007), available at: http://www.oecd.org/std/39974460.pdf (“a meaningful size threshold (t) should be set to avoid the growth of small enterprises distorting the picture. For instance, an enterprise growing from one to two employees would automatically be a high growth enterprise... On the other hand, the size threshold should be low enough to avoid excluding too many enterprises. A
The highest-growth enterprises are considered to be firms with annualized growth in employees of 33% or more a year over a five-year period. The next levels contain firms that expanded their employment by 25%–32%, 17%–24%, and 9%–16% in the last five years. The lowest tier contains firms that expanded their employment between 1% and 8%. These employment growth levels were chosen by aggregating several studies on employment growth in various types of firms. The size threshold of five employees is set to avoid having the growth of very small, closely held corporations distort the picture by adding very few employees over a short period time. Nevertheless, the size threshold was set to be low enough to avoid excluding too many enterprises, especially newly formed corporations in their nascent stages.

Finally, employment is one of the most recognized positive effects of entrepreneurship and, therefore, is an important manifestation of its existence. It is an important factor to consider because not all new firms create new combinations resulting in high economic growth. However, employment growth measures the quantity and not the quality of employment in a firm. It does not tell us anything about the turnover rate of employment, namely how many employees left and joined the firm in

$$\text{Employment Growth}_{(year \ i)} = \frac{\Delta Y}{Y} = \frac{Y_i - Y_{i-5}}{Y_{i-5}} = \frac{Y_i - 1}{Y_{i-5}}$$

For example, in OECD Statistics Directorate, *Measuring Entrepreneurship, A Digest of Indicators, OECD-Eurostat Entrepreneurship Indicators Program* 18 (2008), and in Organization for Economic Co-operation and Development, *Eurstat- OECD Manual of Business Demography Statistics* 61 (2007) the studies compared employment growth in countries considered high-growth enterprises as those with annual employment growth of 20% a year over a three year period and a ten or more employees at the beginning of the observation period. But see, Shaoming Cheng, Roger R. Stough, and Randall W. Jackson, *Measuring and Building High-Quality Entrepreneurship: a Research Prospectus*, 22 THE EUROPEAN J. OF SOC. SCI. RESEARCH, 329, 336 (2009), which denotes high-growth firms as those whose employment has grown at least 30% between 2000 and 2004 in the 1-50 employment category, at least 20% between 2000 and 2004 in the 51-100, at least 10% between 2000 and 2004 in the 100-500 category. Since this proposal does not account for size of firm, it combined these studies and progressively spread the percentages over more tiers of employment growth.
the course of the three years measured. It also fails to provide information on the productivity or the quality of employment in the enterprise. Therefore, as with the other indicators, employment growth cannot solely affirm the innovative character of a firm. It must be combined with other factors in order to add a small piece to a larger puzzle on the entrepreneurial orientation of a firm.

E. Growth Rate

A major part of Schumpeter’s entrepreneurial theory was that the creation of wealth as “[a] firm’s economic performance is generally acknowledged to have two primary dimensions – growth and profitability.”204 There are various areas of economic activity that can reflect the development of wealth: rise in income levels, increasing sales amounts, initiating international trade, surge in the return-on-assets ratio, the number and capitalization of enterprises in the stock market, and so on.205

A common indicator that measures high-growth firms is the average annual growth rate calculated as the total average growth in sales over the last five years. This measure estimates the success of the firm’s products through increases in the firm’s sales volume over a period of time.

\[
\text{Average Annual Growth Rate} \quad (\text{year } i) = \frac{\Delta S / S}{5} = \frac{(S_i - S_{i-5}) / S_{i-5}}{5}
\]

Accordingly, the higher a firm’s average annual growth rate, the more successful the firm is because it is selling more of its products in the market. Schumpeter commented on his inclination to measure entrepreneurial gains via a firm’s assets in his Change and the Entrepreneur essay:

…entrepreneurial gain does not typically consist, and in any case does not necessarily consist, in a current surplus per se. If a man,


for instance, sets up a new industrial organization such as United States Steel, the value of the assets that enter into this organization increases. This increase no doubt embodies, at least ideally, a discounted value of the expected surplus returns. But it is this increase in asset return itself rather than the returns that constitute the entrepreneurial gain, and it is in this way that industrial fortunes are typically created...206

Entrepreneurial gain was portrayed, then, as the initial industrial wealth that derives from a temporary monopoly position prior to the entrance of market competitors that imitate the entrepreneur’s innovation.207 Nevertheless, as with other indicators, the average annual growth rate cannot tell us whether the firm is profitable or whether the increase in sales is attributed to entrepreneurial gains or to later stages of that process when firms fulfill preexisting market demand. This emphasizes the benefits of using a combination of factors to receive a more comprehensive picture of a firm’s orientation to entrepreneurship.

[Note to reader: Part III is still work-in-progress and needs to be further developed]

F. The Scale: Progressive, Flexible and Administerable

Existing indicators of entrepreneurial activity are unsuitable for capturing the complex relationship between entrepreneurship and the law. Legal models are more likely to be successfully implemented when they are designed with three main objectives in mind: fairness, flexibility, and administrability.208 This scale attempts to achieve these three goals. First, the model contains a flexible schedule in the sense that firms are likely to move from one tier to another. Second, the model’s progressivity flows from the combination of various factors and five tiers that allows a fairer, more unbiased characterization. Third, the model is made simple and administrable by focusing on only five main widely-accepted common features of entrepreneurship. These measures are broadly accessible to firms and policy makers, which simplifies the determination of firms’ entrepreneurial viability scores.

206 Joseph A. Schumpeter, Economic Theory and Entrepreneurial History, supra note 1, at 261.
208 Martin J. McMahon Jr., Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself, 50 WASH. & LEE L. REV. 459 (1993) (criticizing the 1986 tax reform as broadening the tax base and grounded on policy analysis, yet some of the most significant provisions failed to implement policies of fairness and simplicity).
Firms cannot possibly possess the same entrepreneurial orientation over time. Schumpeter argued that entrepreneurship is temporary and that “everyone is an entrepreneur only when he actually ‘carries out new combinations,’ and loses that character as soon as he has built up his business, when he settles down to running it as other people run their businesses.” He further noted that nobody is ever an entrepreneur all the time. The same logic applies to firms. Firms cannot be innovative at all times, and their behavior and growth trends vary from year to another. This model takes into account such variations by allowing firms different levels of entrepreneurial activities that match their behaviors.

Using a composite indicator is another way in which this model attains flexibility while maintaining simplicity and administrability. The mathematical combination of individual indicators to a single index allows the incorporation of a multi-dimensional concept of entrepreneurship to be measured, which cannot be captured by any single indicator. This method also provides policy makers and individual managers a comparison point between different companies’ entrepreneurial orientations; it delivers early warnings to firms that are changing their position in the entrepreneurial orientation scale and indicated areas of action; and it can assist in anticipating future entrepreneurial conditions and trends.

Every tier in Figure 1 provides a firm with different amounts of points per indicator. This allows the weighting of the contribution of each level toward the overall entrepreneurial index. For example, firms located on the top end of the scale (Tier A) are highly entrepreneurial and are expected to have the highest proclivity to contribute to economic growth. On the other hand, there could be firms that receive no score at all and are considered trivial, non-entrepreneurial enterprises. As we move up the scale, we come across enterprises that retain more and more entrepreneurial indicators in their respective markets.

209 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 60.
210 THE ENTREPRENEUR, CLASSIC TEXTS BY JOSEPH A. SCHUMPETER, supra note 8, at 301 (“Nobody ever is an entrepreneur all the time, and nobody can ever be only an entrepreneur. This follows from the nature of the function, which must always be combined with, and lead to, others. A man who carries out a "new combination" will unavoidably have to perform current nonentrepreneurial work in the course of doing so, and successful enterprise in our sense will normally lead to an industrial position which thenceforth involves no other functions than those of managing an old firm.”).
211 Avanzini, at 8.
212 Figures in the scale should be adjusted periodically to account for the effects of changes in the economy.
IV. ILLUSTRATIONS OF THE PROPOSED LEGAL MODEL

The legal model presented above serves as a superior alternative to many of the size standards currently dominant in our legal system. This tiered system more adequately captures the entrepreneurial orientations of different types of businesses in the U.S. economy and provides a better proxy for their contributions to our economy. Take, for example, Apple Inc., a well-known firm incorporated in 1977, which puts it at the bottom of Tier E with 1 point for longevity. The company’s innovation efforts (measured as the percentage of R&D from sales) are reported to be 2.1% which places it in Tier E, with 1 point. On the other hand, its innovation productivity is 23%, providing it 15 points in Tier B, and its annual growth rate is 33%, which puts he firm in Tier A, with 20 points. With 66,000 employees, the company’s employment expansion

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**FIGURE 1**

Entrepreneurial Orientation Scale

<table>
<thead>
<tr>
<th>Tier</th>
<th>Points per indicator</th>
<th>Business Longevity (years)</th>
<th>Innovation Efforts (percent)</th>
<th>Innovation Productivity (percent)</th>
<th>Employment Growth (percent)</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>20</td>
<td>8 or less</td>
<td>16 or more</td>
<td>10 or less</td>
<td>33 or more</td>
<td>20 or more</td>
</tr>
<tr>
<td>C</td>
<td>10</td>
<td>16-22</td>
<td>8-11</td>
<td>31-50</td>
<td>17-24</td>
<td>10-14</td>
</tr>
<tr>
<td>D</td>
<td>5</td>
<td>23-29</td>
<td>4-7</td>
<td>51-70</td>
<td>9-16</td>
<td>5-9</td>
</tr>
<tr>
<td>E</td>
<td>1</td>
<td>30-36</td>
<td>1-3</td>
<td>71-90</td>
<td>1-8</td>
<td>1-4</td>
</tr>
</tbody>
</table>

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213 Calculated as firm-financed R&D expenditure divided by total sales. This indicator does not include government-financed research and development as a policy matter. Including government-financed R&D will provide a skewed picture of firm-financed versus government-funded firms and will result in granting benefits to firms that are already advantaged by the access to government funding. Range is based on rates found in Table 2-5 Firm-financed Research and Development as a percentage of sales for the 10 industry Categories, Federal Trade Commission, Statistical Report, Annual Line of Business Report 1977, Report to the Bureau of Economics, 21 (April 1985), available at: [http://www.ftc.gov/be/econrpt/231945.pdf](http://www.ftc.gov/be/econrpt/231945.pdf)

214 Calculated as total R&D Expenditures divided by total R&D Profits.

215 Calculated as net change between the firm’s number of full-time employees at the end of year 5 (in new firms, the most recent year of operation) and year 1, divided by total number of full-time employees at year 5 (in new firms, the most recent year of operation).


217 Source: Forbes.com
in the last year was 28.1%, putting it into Tier B with 15 points. The total entrepreneurial orientation index of Apple Inc. amounts to 51, which indicates that the firm is entrepreneurial-oriented but not excessively so in light of its relatively low innovation efforts.

On the other hand, Newco Inc., a software company formed six years ago, invested most of its resources into R&D, doubled its number of employees, successfully sold its software to several clients, and significantly increased its sales over the last few years. The firm’s total entrepreneurial orientation index is probably at the highest end of the scale. Whereas Pizza Inc., a local pizzeria shop established 20 years ago is currently providing the only local alternative to the major Pizza chains in its area. Pizza Inc. has not significantly changed its number of employees and uses the same baking method instituted by the owner 20 years ago while yielding a stable average annual sales rate over the years.

Accordingly, policy makers should offer incentives through the legal system to firms with an entrepreneurial orientation index of 70–100, as these firms are more likely to – if they are not already doing so – contribute to economic growth. These types of firms already demonstrate an innovative character, increased job creation, and the production of knowledge in a cost-effective way. However, reduced benefits may also be afforded to firms with entrepreneurial orientation indices of 40–70 and 1-40. No benefits should be afforded in the name of entrepreneurship to businesses with low or no entrepreneurial orientation. While firms such as Pizza Inc. contribute to the business diversity and the culture of its locality, these values should be respected and recognized elsewhere and in a different manner.

One of the major advantages of this legal model is its progressive nature and its ability to take into account more than the classic dichotomy of small or large firms. This five-tiered structure aims in the interim to identify firms that possess mixed characteristics or that are on their way to become entrepreneurial and to allow them to also receive certain beneficial treatment, rather than the current discrete and arbitrary size-based approach.

For instance, applying this model in our current tax system improves fairness, promotes simplicity, and increases administrability. Tax incentives granted to small-business investors form one such case. It is a well-known fact that securing credit is an important function that facilitates entrepreneurship. Entrepreneurs that are not capitalists require sources of finance in order to execute their innovations. The legislative purpose of items such as Section 1202 of the Internal Revenue Code (“Tax Code”) is to promote entrepreneurship by encouraging financiers

to invest in innovative firms. However, the current Code focuses on size and offers significant tax benefits to people who operate small firms or own stock in them. Enacted in 1993, Section 1202 allows non-corporate taxpayers to exclude from taxation gains from the sale or exchange of qualified small business stocks. The Tax Code defines a qualified small business stock as that of a C corporation with less than $50 million in aggregate gross assets. Currently, the Internal Revenue Service maintains that 99% of all firms report $50 million or less in assets, so their investors are potentially eligible for this exclusion. But are all firms with gross assets of $50 million or less actually entrepreneurial? Is investment in such firms directly correlated to economic growth? The answer to these questions is “Not necessarily.”

Here is how this legal model is better suited to promoting entrepreneurship while reducing the complexity of the Tax Code and

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218 The legislative intent behind this benefit was to encourage people to invest in small businesses and to foster their growth by offering incentives for high-tech, startup companies and stakeholders that invested in such companies. David O. Kahn, *Tax Tips: A Qualified Small Business Stock Tax Primer*, 23 L.A. LAWYER 17, n15 (2000).


220 Individuals who own qualified small business stock for at least five years (§ 1202(a)(1)) can exclude up to 50 percent of the capital gain on disposition, limited to the greater of 1) $10 million reduced by any previously excluded gain attributable to such issuer, or 2) 10 times the aggregate adjusted basis of the qualified small business stock disposed of in the taxable year at issue. 26 U.S.C. § 1202(b)(1) (2012). See generally Overview of the Conference Agreement on the Revenue Provisions of the Omnibus Budget Reconciliation Act of 1993 (H.R. 2264), Prepared by the Staff of the Joint Comm. on Taxation, 103rd Cong. 3 (Aug. 23, 1993). Joshua E. Husbands, Comment, *The Elusive Meaning of Small Business*, 2 J. SMALL & EMERGING BUS. L. 355, 368 (1998).

221 The C corporation has to be actively engaged in trade or business with less than $50 million in aggregate total assets before and immediately following the issuance of the stock. 26 U.S.C. § 1202(c)(1), (d)(1)(B). Prior to the Tax Reform Act of 1986, the Tax Code provided a reduced tax rate on long-term capital gain rate by providing that “If for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income.” 26 U.S.C. § 1202 (1984). Although this tax benefit was highly debated between 1969 and 1976, in 1978 a heavily lobbied statutory change put that tax benefit into place until the Tax Reform of 1986. See William C. Whitford, *Lowered Horizons: Implementation Research in a Post-CLS World*, 1986 Wis. L. REV. 755, 764 (1986).


firms’ tax compliance costs associated with this Tax Code section.\textsuperscript{224} Section 1202 could be designed to allow a 100% exclusion from taxation gains from the sale or exchange of stocks of firms with an entrepreneurial orientation index of 70–100. These firms are already proven to be innovative, job-creating, high-growth firms that currently promote economic growth. An exclusion of a lesser percentage should be afforded to firms with entrepreneurial orientation indices of 40–70 and 1–40. Accordingly, this tax benefit should be denied altogether to firms with an entrepreneurial orientation index of less than 1, regardless of their size or whether they qualify under the current small-business size standard.

Comparable tax benefits, such as those given in Sections 1045 and 1244 of the Tax Code, can also benefit from the application of the proposed legal model. Section 1045 permits taxpayers to roll over capital gains on the sale of small business stock if the proceeds are reinvested in another qualifying small business stock.\textsuperscript{225} Section 1244 treats losses incurred by the sale of a small business corporation’s stock (with surpluses of $1 million or less) as ordinary losses and not as capital losses, resulting in a bigger write-off.\textsuperscript{226} The legislative purpose of these provisions was to push down the effective tax rate on small business investment to zero if all proceeds are continuously reinvested in new small businesses.\textsuperscript{227} Nevertheless, there is a greater chance that these tax provisions will accomplish their goals and spur economic growth by incentivizing investments in entrepreneurial firms rather than all “small”-

\textsuperscript{224} General Explanation Of The Revenue Act Of 1978 at 194, (H.R. 13511, 95th Congress, Public Law 95-600) (holding that many small business firms do not reap the full benefits they are entitled to—either because they are not familiar with the myriad aspects of the code or because they do not get adequate advice on how to meet the various definitions of a “small business”).

\textsuperscript{225} Id. 26 U.S.C. § 1045 (2012).

\textsuperscript{226} 26 U.S.C. § 1244(a) (2012). A “small business corporation” is a corporation with an aggregate amount paid in surplus of $1 million or less at the time of issuance. Today, about 32 percent of all public companies are likely to receive this benefit. See Mergent Online, Advanced Search Tool for U.S. Active and Inactive Corporations by Stockholder Equity Less than $1 Million. http://www.mergentonline.com/login.php

\textsuperscript{227} Victor Fleischer, The Rational Exuberance of Structuring Venture Capital Start-ups, 57 TAX L. REV. 137, 165 (2003) (arguing that the effect of qualified small business stock subsidies in sections 1202 and 1045 cause venture capitalists to favor the C corporation form of incorporation.) But see: John W. Lee, A Populist Political Perspective of the Business Tax Entities Universe: “Hey the Stars Might Lie But the Numbers Never Do”, 78 TEX. L. REV. 885 (2000) (arguing that section 1202 is unlikely to constitute a major factor in choice of tax entity due to the interplay of this preference with the Alternative Minimum Tax (AMT)).
scale firms. Size has been proven an inadequate proxy for innovative firms that create value and advance the economy.  

Finally, the current R&D credit provides a tax credit equal to 20% of qualifying research expenses in excess of a base amount, a 100% tax credit for amounts paid for qualified research in an eligible small firm. An eligible small business is defined here as a business in which the taxpayer does not own a 50% or greater interest and in which there are 500 or fewer employees, which the Small Business Administration reports to amount to over 99% of all firms. The same graduated scheme discussed above could be implemented here as well. The R&D credit could be designed to allow a 100% credit for qualifying research expenses to firms with an entrepreneurial orientation index of 70–100, and a lesser credit percentage to firms with entrepreneurial orientation indices of 40–70 and 1–40, respectively. 

[Note to reader: Part IV is still work-in-progress and needs to be further developed]

V. CONCLUSION

Entrepreneurship is first and foremost a mindset... To turn a business idea into success requires the ability to blend creativity or innovation with sound management and to adapt a business to optimi[ze] its development during all phases of its life cycle. This goes beyond daily management: it concerns a business’ ambitions and strategy. 

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228 98 IOWA L. REV. __ (2013), supra note 19.
229 The Small Business Job Protection Act of 1996, P.L. 104-188, 110 Stat. 1755 (Aug. 20, 1996). The base amount is determined by multiplying the fixed-base percentage by the taxpayer’s average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined. 

232 See supra text accompanying note 12.
Given the diversity of effects and indicators of entrepreneurship, no single indicator can ever adequately cover entrepreneurship. Nevertheless, this article is the first attempt to extend Schumpeter’s entrepreneurship theory to create a legal model for entrepreneurship orientation. Law and entrepreneurship are two disciplines that are at the center of current public discourse. Thus, lawyers and law scholars play a key role in the promotion and development of both entrepreneurship and the law.

Schumpeter portrayed innovation as the essence of the entrepreneurial function. He argued that entrepreneurs generate “creative destruction” vital for sustaining economic growth by forcing structural changes across markets and industries. These entrepreneurs reform and revolutionize patterns of production by “exploiting a new technology, developing a new source of supply, reorganizing an industry, or the like.” Accordingly, policy makers should develop optimal legal structures that facilitate economic growth through entrepreneurship. While small livelihood businesses such as the local Laundromat, coffee shop or locksmith may be a vital element of their neighborhood’s culture, there should be a manner to reward firms that promote values such as business diversity than the current blind size-standard system.

This paper proposes a legal model to replace some of the current size standards by capturing the main dimensions of firms with entrepreneurial viability and characteristics. This model focuses on firm behavior rather than individual characteristics. As my previous article demonstrated, a firm’s size alone does not attest to the entrepreneurial capability of the firm. Rather, organizational actions and operations are what make it

236 Id. (1997).
237 For the history of entrepreneurship see, Paul H. Wilken, Entrepreneurship: A Comparative and Historical Study 59 (1979) (“Economic entrepreneurship involves the combination of economic factors of production—land, labor, capital, and technology—and economic consequences, usually the production of goods and services.”)
238 Joseph A. Schumpeter, The Theory of Economic Development, in The Entrepreneur, The Entrepreneur, Classic Texts by Joseph A. Schumpeter, supra note 8, at 57 (“The carrying out of new combinations we call ‘enterprise’; the individuals whose function it is to carry them out we call ‘entrepreneurs’”).
239 David E. Pozen, We Are All Entrepreneurs Now, supra note 7, at FN 29.
240 98 IOWA L. REV. __ (2013) supra note 19, at __.
entrepreneurial. Moreover, it is easier to measure a firm’s behavior than to attempt to deduct a common characteristic inherent in all entrepreneurial processes.\textsuperscript{241} Consequently, a behavioral approach, rather than a characteristic approach, is the basis of this entrepreneurial legal model.\textsuperscript{242}

The proposed legal model’s elasticity allows firms to move along the scale as they become more or less entrepreneurial-oriented. This adds up to greater fairness when legislators apply this scale and the score for each firm. While there is not necessarily a correlation between each of the characteristics within the individual tier, as a composite group it instead provides an important indication.\textsuperscript{243} When a firm’s feature changes, it can alter its position on the scale accordingly. This mobility is beneficial in preventing the scale from either understating or overstating a particular firm’s entrepreneurial significance.

Finally, the categories in the legal model are far from being exhaustive, and adopting them is in no way a restricting characteristic of the entrepreneurial orientation approach. This model is intended to allow policymakers to develop, modify, and widen the focus on entrepreneurship while setting up a better measurement metric than the current emphasis on size.

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\textsuperscript{241} Jeffrey G. Covin & Dennis P. Slevin, \textit{A conceptual model of entrepreneurship as firm behavior}, in ENTREPRENEURSHIP: THEORY & PRACTICE, 16 (1991)(“The issue of measurability also gives advantage to a behavioral model of entrepreneurship. Specifically, behavior is, by definition, overt and demonstrable. Knowing the behavioral manifestations of entrepreneurship, we can reliably, verifiably, and objectively measure the entrepreneurial level of firms. This is important because the development of entrepreneurial process knowledge hinges on our ability to accurately differentiate between more and less entrepreneurial firms.”)

\textsuperscript{242} Jeffrey G. Covin & Dennis P. Slevin, \textit{A conceptual model of entrepreneurship as firm behavior}, in ENTREPRENEURSHIP: THEORY & PRACTICE, 16 (1991).

\textsuperscript{243} For example, if a firm invest in purchasing new technology that improves its entrepreneurial viability, and this change indeed results in increasing sales, this will be reflected in the innovation productivity and innovation intensity, or later on through the firm’s profitability.