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THE ENTREPRENEURIAL FUNCTION

by Gary North

And Joseph said unto Pharaoh, The dream of Pharaoh is one: God hath shewed Pharaoh what he is about to do... This is the thing which I have spoken unto Pharaoh: What God is about to do he sheweth unto Pharaoh (Gen. 41:25, 28).

Joseph had demonstrated his administrative competence to Potiphar, captain of the guard, and to the Egyptian jailer. He had also shown his ability to interpret prophetic dreams to the Pharaoh's butler. The butler recommended Joseph to Pharaoh when Pharaoh confronted a dream which he could not understand. They brought him from the dungeon, and Pharaoh described his visions of the seven fat animals being devoured by the seven lean ones, and the seven fat ears of corn being devoured by the seven lean ones. Joseph informed Pharaoh that the dream revealed the coming of seven years of agricultural prosperity, to be followed by seven years of famine. As for the two separate visions, "the dream was doubled unto Pharaoh twice; it is because the thing is established by God, and God will shortly bring it to pass" (41:32). Joseph entertained no doubts whatsoever. This was the prophetic word of God.

Pharaoh wisely listened to Joseph's interpretation. When Joseph then recommended that Pharaoh seek out a man "discreet and wise, and set him over the land of Egypt," to direct the collection of one-fifth of the grain during the seven years of plenty, Pharaoh appointed Joseph (41:33-43). Not only did Joseph's prophecy come true, but he also once again proved himself to be a reliable and efficient administrator of men. Because of his unique combination of economic foresight (in this case prophetic in nature) and efficient administration, Joseph stands out as the Bible's archetype of the entrepreneur.

It is the task of the entrepreneur to forecast the future accurately, at least in so far as it affects his business, and then to plan effectively to meet the economic demands of consumers in that expected future. **Of all the economic functions of the free market, this is the pivotal one.** It is the ability of men to estimate the demands of their fellow men in the future, and then to produce in terms of those demands without wasting scarce economic resources, which makes it possible for society to advance beyond the most primitive methods of production. The individual who does plan efficiently for the future, producing goods or services that satisfy the demand of consumers at the prices he expected them to pay, reaps a reward, entrepreneurial profit or pure profit. It is an **economic residual**, funds remaining after payment has been

made for raw materials, labor, capital equipment, interest, rent, and taxes. The person who misforecasts the future, or who is unable to foresee the costs of delivering his goods and services to the waiting consumers, eventually produces losses. He is forced to dip into his capital in order to stay in business. If the losses continue, he loses control of capital resources, and others who are able to meet future consumer demand with less waste are able to buy these resources from him. In the competitive auction market for scarce economic resources, the profit-making individuals are the more effective bidders for resources, transferring them to their own companies in order to meet the demands of consumers. The consumer benefits, for he is able to purchase more resources at the end of the production process, precisely because there has been less waste of land, labor, and capital in delivering the goods to him. **The consumers therefore determine the success or failure of entrepreneurs.** Those who waste resources by failing to meet consumer demand at prices the consumers, through buyers' competition, are willing to pay, are penalized by consumers, while those who are successful are rewarded with entrepreneurial profit. A free market encourages **consumer satisfaction and economic efficiency.**

Profit is therefore a residual accruing to those who deal on a day-to-day basis with the inescapable uncertainties of the future. **Men are not omniscient. We cannot see the future perfectly.** We are limited creatures. Even Jesus, in His Incarnation as perfect man, admitted that He did not know—in terms of His human nature—when the day of judgment is to occur (Matt. 24:36). Creatures must respect their own limitations. By encouraging specialists in economic forecasting to administer scarce economic resources, consumers seek to mitigate the uncertainties of life. By permitting entrepreneurs the right to keep the economic residual, profit, of their activities in meeting consumer demand, the consumers insure that their needs will be met with greater efficiency. The burden of bearing uncertainty is picked up by those willing to do it, and their incentive is the lure of profit.

The consumer is the beneficiary of the entrepreneurial function, Frank H. Knight concluded. Because others are willing to become entrepreneurs, or as they are also called, **speculators**, the consumer can shift much of the responsibility for predicting the future to these specialists. In fact, the entrepreneurs make it their business to know what the consumer will want in the future even before the consumer knows. We know, for example, that the consumer seldom contracts in advance for the delivery of goods and services. Why not? "A part of the reason might be the consumer's

uncertainty as to his ability to pay at the end of the period, but this does not seem to be important in fact. The main reason is that he does not know what he will want, and how much, and how badly; consequently he leaves it to producers to create goods and hold them ready for his decision when the time comes. The clue to this apparent paradox is, of course, in the 'law of large numbers,' the consolidation of risks (or uncertainties). The consumer is, himself, only one; to the producer he is a mere multitude in which individuality is lost. It turns out that an outsider can foresee the wants of a multitude with more ease and accuracy than an individual can attain with respect to his own. This phenomenon gives us the most fundamental feature of the economic system, **production for a market**, and hence also the general character of the environment in relation to which the effects of uncertainty are to be further investigated."²

Does this mean that bureaucrats operating at the very top levels of government planning agencies are better able to foresee the needs of consumers than the consumers are? Not necessarily. What we are comparing is not "consumers" vs "government forecasters" in the realm of forecasting future consumer demand, but rather "consumers served by profit-seeking, competitive entrepreneurs" vs. "consumers served by Civil Service-protected, guaranteed tenure, monopolistic government planners." The fact that government planners have access to reams of data concerning **past** decisions of consumers and producers means very little. **The crucial ability is to make correct assessments about the uncertainties of the future**, meaning those aspects of the economic future that are not subject to computerization or even statistical probabilities. It is the presence of incessant **change** in human affairs that calls forth the skilled and not-so-skilled entrepreneurs in their quest for profits. The market provides a mechanism of economic competition which sorts out the successful from the unsuccessful entrepreneurs. There is no comparable mechanism operating in government, for government has a monopoly of support (taxation) and very often a monopoly of supply operations, such as the delivery of first-class mail which insulates it from the competitive framework of the open market.³ Knight's warning is significant: "The real trouble with bureaucracies is not that they are rash, but the opposite. When not actually rotten with dishonesty and corruption they universally show a tendency to 'play safe' and become hopelessly conservative. The great danger to be feared from a political control of economic life under ordinary conditions is not a reckless dissipation of the social resources so much as the arrest of progress and vegetation of life."⁴ Bureaucracy favors present-oriented risk-(uncertainty-) averters.⁵

What service is it that the entrepreneur performs in order to receive his residual? He perceives a special opportunity in the future. He believes that consumers will be willing and able at a specific point in time to pay more for a particular good or service than today's entrepreneurs think they will be willing and able to pay. Because of this lack of perception on the part of his competitors, the entrepreneur finds that the scarce economic resources that are used in the production of the good or service are underpriced in relation to what they would be if all entrepreneurs recognized the true state of future consumer demand. The entrepreneurs are middlemen for consumers, actual surrogates for them. They enter the markets for production goods and compete among each other in order to buy them, but always because they intend to sell the results of production to con-

sumers. If an entrepreneur sees that certain factors of production are presently underpriced in relation to what consumers in the future really will be willing and able to pay for them in the form of final consumer goods, then he has a profit opportunity. (Of course, he has to pay a rate of interest, since future goods are always discounted in comparison to what people will pay for present goods, and he has to tie up the use of the scarce resources until the time he can get the finished products to market.) The entrepreneur enters the market and begins to buy up production goods—land, labor, capital—in order to manufacture the consumer goods. Or he may simply rent these factors of production. In any case, he removes them from the marketplace for a specific period of time. When he brings the final products to market as finished consumer goods, he raises their price to the level determined by the competitive auction bids of consumers. In short, he makes his profit by estimating in advance what future consumers, in bidding against each other, will be willing to pay in a free market for the output of his production process.

The entrepreneur does not compete against consumers, except in so far as there are zones of ignorance in the minds of both consumers and his competitors, other potential sellers, concerning the market price of the goods or services. In a highly competitive market, these zones of ignorance are drastically reduced. People know pretty well what items sell for in the marketplace. The entrepreneur is always competing against other entrepreneurs—the middlemen who act for the benefit of consumers—who also produce in order to meet future consumer demand. When the finished consumer goods or services are offered for sale, the "auctioneer"—the seller of goods—is guided by the competitive bids of competing consumers. He is unable to set any price he wants to set, though of course he prefers to receive a high price. He sets his price in response to consumer bids, so as to "clear the market." He wants to sell every item scheduled for sale in the particular time period. He cannot squeeze any more money out of the consumers than they are willing and able to pay. Other sellers can also enter the market and offer goods or services for a lower price, and he has to consider this possibility, too. In short, **sellers compete against sellers, while consumers compete against consumers.**

If the entrepreneur was correct in his original estimation of the extent of consumer demand, and if no unforeseen contingencies have disrupted the expected cost of producing the final goods, and if no new sources of supply are brought to market that he had not been able to product, then the entrepreneur gets his expected price per unit sold. He has "bought low" and has been able to "sell high." He sells to the highest bidders. He reaps his reward, entrepreneurial profit. It is the residual which remains after he has paid for all production inputs, including interest and his own management wage (the equivalent income that he had to forego because he could not sell his services to other entrepreneurs during the time he was working in his own company). If all has gone according to his original plan, then he has profited. But one fact must be understood: **he has not profited at the expense of consumers.** Consumers have not "lost" because of his presence in the market as a seller. He has profited at the expense of rival entrepreneurs who failed to see the opportunity for profit, and who failed to enter the resource market for scarce factors of production. They stayed out, thereby allowing him to buy up those production factors less expensively. But the consumers have unquestionably benefited. He has served the highest-bidding consumers well. What if he had never bothered to buy up those

producer goods, pay the interest, and bear the risks of production? What if he had never brought the goods or services to market? How would that have helped those consumers who wanted the goods so much that they were willing to pay him top prices? He made more of these goods available to them than they would otherwise have had offered to them by sellers. He has been their benefactor—at a profit.

Professor Mises summarized the nature of profits in a straightforward manner: "If all entrepreneurs were to anticipate correctly the future state of the market, there would be neither profits nor losses. The prices of all factors of production would already today be fully adjusted to tomorrow's prices of the products. In buying the factors of production the entrepreneur would have to expend (with due allowance for the difference between the prices of present goods and future goods) no less an amount than the buyers will pay him later for the product. An entrepreneur can make a profit only if he anticipates future conditions more correctly than other entrepreneurs."⁸ While there is always considerable intellectual risk in discussing what anything would be like if man were not man—specifically, what profits would be if men were omniscient—nevertheless, the reader should grasp what Mises is saying. Profits and losses are part of the human condition, precisely because **man is not God. It is the quest for a risk-free, uncertainty-free, profit-and-loss-free world which is demonic. It is the demand that we remake man into God, that man become omniscient, that man transcend the limits of his creaturehood.**

It is imperative that we understand the difference between **profit-seeking** and **gambling**, though both aim at predicting the future. Murray Rothbard's analysis is illuminating in this regard. "It is not accurate to apply terms like 'gambling' or 'betting' to situations either of risk or of uncertainty. These terms have unfavorable emotional implications, and for this reason: they refer to situations where **new** risks or uncertainties are **created** for the enjoyment of the uncertainties themselves. Gambling on the throw of the dice and betting on horse races are examples of the deliberate creation by the bettor or gambler of new uncertainties which otherwise would not have existed. The entrepreneur, on the other hand, is not creating uncertainties for the fun of it. On the contrary, he tries to reduce them as much as possible. The uncertainties he confronts are already inherent in the market situation, indeed in the nature of human action; someone must deal with them, and he is the most skilled or willing candidate."⁷ Market speculation may be indulged in by the very same men who, in their off hours, enjoy betting on horses or dice, but the economic effects are vastly different. The market speculator tries to reduce uncertainty for the sake of future consumers (which, of course, may well include himself), while the gambler is a present consumer of the joy or masochism of a game. He is a public benefactor if he guesses correctly in his capacity as a market forecaster. He is simply a winner at a game—matched by losers in the same game—when he forecasts correctly as a gambler. He has put his capital at risk to serve future consumers as a market speculator. He has put his capital at risk to serve himself as a believer in a chance-dominated universe when he enters a game of chance. As a market forecaster, he acknowledges his limits as a creature, and deals with the world of the future in which men can see only darkly. He cannot escape living in such a world without actually dying. He serves others by entering into market forecasting activities. But as a gambler, a man risks losing his God-given capital

assets in a game of chance, probably in a game in which the laws of probability for winning are against him (and if they are for him, they are against his opponents in the game). He affirms a universe of luck, of chance, of non-random benefits for those who take needless risks with their capital. In short, the market speculator affirms the universe God has created, while the gambler affirms a very different world. The speculator tries to conserve capital for his own profit and for the benefit of future consumers. The gambler wastes capital in terms of a philosophy of impersonal chance or personal luck, neither of which is a valid assumption concerning a created universe which is governed by an omniscient, omnipotent, sovereign personal God.

It is no doubt true that it is impossible for anyone, including the entrepreneur, to sort out precisely what part of his income is a wage for management services, what part is an interest return for the money he puts into the business, and what part is pure profit. But what we must understand is that these are **theoretically** distinct aspects of the product process. If we try to pay an entrepreneur a **fixed wage for managerial services, he will quit, or cease bearing the uncertainties of predicting the future, or cease making consistently accurate predictions.** If we pay him a predictable interest return on his money, and no more, then we have made him an investor, not an entrepreneur. There is an entrepreneurial function which cannot be remunerated in advance precisely because entrepreneurial profit is a residual which at best is estimated effectively only by future-predicting entrepreneurs.

It might be argued that Joseph's experience in Egypt serves as a biblical justification of central planning by the civil government. Such an argument, while no doubt tempting, overlooks the key fact in this incident: Pharaoh had been given a direct revelation by God, and Joseph came to him as God's prophet with the ability to interpret Pharaoh's dream perfectly. Only on this assumption, namely, that we can expect truly prophetic omniscience from salaried or elected officials of the central government, can the case be made for universal central economic planning. If this assumption is rejected, then central economic planning initially has no greater claim to biblical sanction than private economic forecasting does.

Is the assumption correct? Is there some feature about becoming a State official which in some way endows a person with a prophetic mantle? What biblical evidence do we have for such an ~~assumption? Is any foreign prisoner who has served two years of~~ an indeterminate jail sentence a predictably effective interpreter of visions given to national leaders? Would anyone wish to build a theory of political economy on such a premise? Could we create a governmental planning structure in terms of such a premise? Could we create a governmental planning structure in terms of such an operating presupposition about the nature of civil government?

The consequences of Egyptian economic planning by Joseph must also be borne in mind. The entire nation, excepting only the priests, went into bondage to the Egyptian State (Gen. 47:13-22). All land, except that owned by the priests, became the possession of the Pharaoh. The people survived the famine, which they might not have been able to do had it not been for Joseph's entrepreneurship, but they and their heirs became servants of the Pharaoh and his heirs.

It was basic to the religions of antiquity that the State was in some fundamental way divine, or linked to the divine through the ruler. Egypt's theology was especially notable for its adherence to

the theology of a divine ruler. The Pharaoh was supposedly the descendent of the sun god. Only the Hebrews, with their doctrine of the Creator-creature distinction, avoided the lure of a theology of immanent divinity. The outcome of such a humanistic theology, when coupled with a mechanism of State economic planning, was enslavement. This was the curse of what Wittfogel has called oriental despotism.⁸

The Hebrews, in stark contrast, were told to worship God, and only God, as divine. The State, clearly, is not divine, and any attempt to make it divine—the sole representative of God on earth—was understood to be demonic. Officials were constantly told to remain honest stewards of the great King. The office of prophet was decentralized, and prophets continually challenged kings, princes, priests, and average Hebrew citizens when they turned away from God and His law. God sent a shepherd like Amos to speak to the people; they were expected to heed this shepherd's word, not the king and his court priests. The civil government is no more trustworthy than any other human institution. All institutions are to be under the jurisdiction of God. There is no monopoly of sovereignty on earth, except God's written word, the Bible.

By decentralizing the office of prophet, God insured that His people would not be compelled to listen exclusively to false prophets catering to the civil government rather than serving God. When the people were stiff-necked, refusing to heed His word, He punished them by allowing them to believe the false reports provided by the court's false prophets (Ezek. 14:1-5). The curse on their ethical rebellion was quite specific: the imposition of centralized decision-making by corrupt kings and their officially sanctioned prophets.

We never face a choice of "planning" vs. "no planning." The only question is: "Whose plan?" When economic planning is decentralized, and decisions are made by owners of private property, society is shielded from the risks of massive, centralized error. An erroneous decision made by a particular privately owned firm may cost its shareholders dearly, and consumers who would have purchased the goods that would have been made, had the firm not embarked on its error-filled course, no doubt are harmed. There has been waste. Nevertheless, the majority of consumers are protected because competing firms and suppliers can step in and satisfy consumer demand. The rival suppliers help to smooth out the disruptions caused either by the unforeseen external circumstances or the operations of the erroneous firm.

When a monopolistic central planning agency makes an error in forecasting the economic future, large segments of the population suffer. There are few legal alternatives open to potential buyers. Black market operators may step in, for a high price, and smooth out the disruptions in supply, but buyers will bear higher risks in dealing with these suppliers, and they will pay higher prices than would have been necessary had private firms been allowed to compete with State planners. Bureaucrats, shielded as they are by tenure, trade union restrictions, or Civil Service regula-

tions, do not have the same incentives to bear uncertainty successfully, when compared to the incentives offered to the private entrepreneur. Bureaucrats are not rewarded directly with profits, nor are they immediately fired. The carrot and the stick are only indirectly related to any given decision made by a central planning agency. Blame for error is easily transferred in any thing as complex as a national economy. The consumers cannot weed out the inefficient planners in a direct, forceful manner when planners are paid functionaries of the political State. By monopolizing the entrepreneurial function, the State creates a planning structure that is far too rigid, far less sensitive to shifts in consumer demand and resource supplies, than the decentralized planning of profit-seeking entrepreneurs. This **inflexibility in the face of ceaseless change** drastically increases the risk of **devastating, centralized, universal failure**. And even when the State's bureaucrats turn out to be successful forecasters, as Joseph was in Egypt, the citizens who benefit from this accurate forecasting run the risk of becoming increasingly dependent on the State. As those in Egypt learned during the reign of the Pharaoh of Moses' day, **successful State planning in one period in no way guarantees the continued success of central planners in subsequent periods**. But successful State planning does increase the share of capital assets controlled by the State and its bureaucratic functionaries, thereby insulating them in subsequent decisions from private competition in the decision-making process. The Egyptians learned this lesson the hard way.

¹On profit as an economic residual which results from accurate forecasting, see Frank H. Knight, *Risk, Uncertainty and Profit* (New York: Harper Torchbook, [1921] 1965); Ludwig Von Mises, *Human Action* (3rd ed.; Chicago: Regnery, 1966), pp. 289-94; Murray N. Rothbard, *Man, Economy and State* (Ottawa, Illinois: Green Hill Publishers, [1962] 1976), ch. 8.

²Knight, *Risk, Uncertainty and Profit*, p. 241.

³Ludwig Von Mises, *Bureaucracy* (New Rochelle, New York: Arlington House, [1944] 1969). On the inability of governments to make accurate economic assessments of costs and benefits, see Mises essay, "Economic Calculation in the Socialist Commonwealth," (1920), in F. A. Hayek (ed.), *Collectivist Economic Planning* (London: Routledge & Kegan Paul, [1935] 1963), ch. III. He expanded his analysis of this topic in his book, *Socialism: An Economic and Sociological Analysis* (New Haven, Conn.: Yale University Press, [1922] 1962), Book II, chaps. 1, 2.

⁴Knight, *op. cit.*, p. 361.

⁵Gary North, "Statist Bureaucracy in the Modern Economy," in North, *An Introduction to Christian Economics* (Nutley, New Jersey: Craig Press, 1973), ch. 20.

⁶Mises, *Human Action*, p. 293.

⁷Murray N. Rothbard, *Man, Economy and State*, pp. 500-01.

⁸Karl A. Wittfogel, *Oriental Despotism: A Comparative Study of Total Power* (New Haven, Conn.: Yale University Press, 1957).

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