Eugen von Böhm-Bawerk and Frank Fetter: Two Neglected Theories of Entrepreneurship

Abstract

This paper examines the neglected theories of entrepreneurship advanced by Eugen von Böhm-Bawerk and Frank A. Fetter. Both of these authors stresses that ownership of capital, uncertainty-bearing, and decision-making comprise the core of the entrepreneurial function, and are thus the determinants of profit and loss. Due to this approach, both theorists arrive at conclusions similar to those of their contemporary Frank Knight, whose work they anticipated to some extent. Furthermore, both may be included in histories of the specifically Austrian approach to entrepreneurial theory, among economists such as Richard Cantillon and Ludwig von Mises.

The Historical Neglect of Böhm-Bawerk and Fetter

Despite tremendous erudition in the field of economic theory, Eugen von Böhm-Bawerk never dealt at great length with the theory of the entrepreneur, although his work on the theory of interest, and consequently on the separation of the different components of income, was closely related. This has led both historians of thought and entrepreneurial theorists to neglect his writings on the subject. For instance, contemporary surveys of Böhm-Bawerk’s work have little or nothing to say on this subject (Garrison, 1999; Hennings, 1987, 1997), and other examples are abundant. Hawley (1892) bases his criticism of Böhm-Bawerk’s interest theory on the claim that interest cannot be explained without also explaining profit, which Hawley claims Böhm-Bawerk did not do. Frank Knight’s (at the time) contemporary survey of profit theories in the Mengerian tradition does not even mention Böhm-Bawerk (Knight, 1933 [1921], pp. 28-30). Hébert and Link comment that Böhm-Bawerk largely neglected the entrepreneur, but do note that he briefly considered the problem of the determination of profit (Hébert and Link, 1988, p. 69). Pribram likewise maintains that “Böhm-Bawerk did not advance a theory of profit strictly speaking”
(1983, p. 330). Hirshleifer (1967) claims Böhm-Bawerk falsely homogenized the entrepreneur and capitalist, combining the separate categories of entrepreneurial profit and interest, a criticism shared by Hawley (1892).¹ Schumpeter is more ambiguous, in one place considering Böhm-Bawerk’s approach unsatisfactory because it combines classical with neoclassical insights (Schumpeter, 1954, p. 893n2), but in another, remarking that Böhm-Bawerk was to Schumpeter’s knowledge the first to advance an uncertainty-bearing, entrepreneurial-judgment approach to profit (Schumpeter, 1989 [1951], p. 257).

The general view then is that Böhm-Bawerk’s writings do not contain significant insights into the theory of entrepreneurship, due either to simple error or to complete neglect of the subject. These views, though intuitively plausible, warrant scrutiny from historians of thought. The purpose of this paper is to show that in fact, Böhm-Bawerk’s approach, though not developed systematically, is more nuanced and coherent than is typically thought, and is deserving of more attention than the one or two sentences typically devoted to it. In what follows, I shall gather together Böhm-Bawerk’s scattered discussions of entrepreneurship and profit in order to show, first, that he clearly differentiated between profit and interest payments, and second, that he did have a distinct theory of entrepreneurial profit. Furthermore, Böhm-Bawerk represents part of a tradition in entrepreneurial thinking harking back at least to Richard Cantillon, and continuing through the work of Frank Fetter and Frank Knight. To emphasize this point, I conclude with a brief discussion of the similarities between Fetter and Böhm-Bawerk.

The work of Frank Fetter is also not usually mentioned in histories of entrepreneurial theory. Knight’s (1933 [1921]) survey of American authors on the subject hardly mentions

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¹ Other contemporaries of Böhm-Bawerk—e.g. MacVane (1890) and Mixter (1902)—may also take this view, but an explication of their views is difficult because terms such as “profit” and “interest” are often used inconsistently or ambiguously.
Fetter, and Schumpeter’s (1954) discussion does not reference him at all. Of contemporary studies, Hébert and Link (1988, pp. 90, 99n4), for example, cite Fetter only in relation to a dispute with Herbert Davenport (discussed below), and broader surveys reference Fetter with regard to other contributions to economic theory (Pribram, 1983; Blaug, 1985). This research notwithstanding, Fetter did develop a coherent and suitably complex theory of the entrepreneur. This theory has been briefly outlined in Salerno (2008). However, a fuller analysis has not been attempted, and Fetter’s place in the history of entrepreneurial thought has not been established. These are gaps which the present paper seeks to fill, at least in part. This paper deals with the core propositions of Fetter’s theory, and not with the many insightful comments he makes on related issues. Fetter’s writings also contain many ideas which would only be fully addressed decades later, such as the problems of managerial organization and incentives (1915, Chapter 27) and the formation of the firm as a process of increased specialization in risk-taking (1915, Chapter 29). These topics, however, are left for future research.

We will examine the entrepreneurial theories of Böhm-Bawerk and Fetter in turn. The first section discusses Böhm-Bawerk’s somewhat embryonic entrepreneurial theory, pointing out his distinction between profit and interest. It also mentions his emphasis on capital ownership, judgment, and the bearing of uncertainty as the core of the entrepreneurial function, and as the sources of profit and loss. The second major section explores the more developed theory of Fetter, treating his definition of enterprise and the entrepreneur, the meaning of profits and losses, and the problems of entrepreneurial judgment. It also shows how to a limited extent Fetter anticipated Knight’s distinction between risk and uncertainty. The final section concludes with a summary of a dispute between Fetter and Herbert Davenport, which may help to explain Fetter’s absence from the literature.
Böhm-Bawerk’s Theory of Entrepreneurship

In addition to the comments mentioned in the introduction, it is helpful to provide additional background by mentioning a criticism of Böhm-Bawerk by his contemporary, Frederick B. Hawley. Hawley’s general contributions to entrepreneurial theory are discussed in Hébert and Link (1988, pp. 87-90), but I wish to focus on his criticism of Böhm-Bawerk, which inspired much of his other writing on the subject. Hawley’s assessment of Böhm-Bawerk’s approach to profit is fairly typical. He claims that it is evident that profit is… looked upon as simply the wages of management… and the undertaker as no more than the manager of the industry. The fact that he enjoys the sole control of the capital engaged is regarded as a mere incident of the personal efforts he expends in conducting the business. This view of the undertaker necessitates classing him among laborer. (Hawley, 1892)

Hawley intends with this critique to emphasize his own position, that profit is a composite income reflecting returns to several types of behavior. From this claim, Hawley derives a number of other objections which I mention throughout this paper. I will show that such views of Böhm-Bawerk misrepresent his position: as I will show, profit is for him more than a wage, and is in fact a distinct branch of income, Hawley’s remarks notwithstanding.

At the beginning of his treatise on capital and interest, Böhm-Bawerk makes it clear that the problem of interest is his principal concern, to the exclusion of the problem of entrepreneurial profit:

The difficulties which surround our subject, the problem of interest, are so great that I can have no desire to increase them by introducing the complication of a second difficult problem. I shall therefore refrain from investigating or deciding the problem of the entrepreneur’s profit… The question of whether
the so-called entrepreneur’s profit is or is not income on capital I shall intentionally leave open. (Böhm-Bawerk, 1959, I, p. 7)

This claim however belies later arguments made by Böhm-Bawerk regarding the essence of entrepreneurship and entrepreneurial profit. It is possible that the above remarks are meant only to anticipate the discussions in the first volume of Böhm-Bawerk’s treatise, and that they are to be relaxed in later volumes after the problem of interest has been addressed. Whatever the case, by carefully discussing the boundaries of interest theory, at the very least Böhm-Bawerk opened the way for a theory of the entrepreneur. The above passage also indicates in passing that Böhm-Bawerk did think of the problems of entrepreneurial profit and interest as distinct, even if it is the case that both are tied to the theory of capital. His exact thoughts in this regard are the subject of this paper.

In the opening pages of the first volume of his treatise, Böhm-Bawerk describes the scope of the problem of entrepreneurship, and speaks favorably of a theory which treats of a distinct entrepreneurial function capable of yielding profit. He appears to have several specific ideas in mind when he describes the entrepreneurial function:

For it is not at all unreasonable to doubt whether the entire excess of proceeds over costs that is realized by an entrepreneur from a process of production should be credited to his capital. Certainly it should not be, if the entrepreneur simultaneously occupies the position of a worker in his own enterprise, for work performed. But even if he does not personally participate in the labor of production, he contributes a certain measure of personal effort, either by reason of the intellectual effort represented by his supervision, or by his formulating policies for the business to follow, or at the very least because of the act of will by which he determines that his means of production shall be enlisted in the service of that particular enterprise. One component would be the result of contributing capital— the originary interest, as it were, and the other the result of the entrepreneur’s effort. (Böhm-Bawerk, 1959, I, p. 6)
Even if the entrepreneur were simply a wage earner in his own enterprise, his income would still be distinct from interest payments. But of course Böhm-Bawerk goes further, describing the “personal effort” of the entrepreneur which extends beyond simple wages: a personal judgment which the entrepreneur exercises which is peculiar to him, his “supervision.” The judgment in question concerns the choice to allocate capital goods to competing processes of production. The entrepreneur is then an entrepreneur-capitalist; entrepreneurs exercise control over capital goods which are used in production. Böhm-Bawerk does not dwell on any possible differences between the capitalist and entrepreneur other than to note the two distinct returns earned by the capitalist-entrepreneur: an originary interest payment, and a return to an entrepreneurial decision-making function. The element of time is not discussed here, but as we shall see below, does play a role in this theory of entrepreneurship.

Böhm-Bawerk proceeds from this discussion to mention the practical difficulty in this theory in separating exactly the returns to capital and entrepreneurial decision-making. He gives a simple numerical example which portrays entrepreneurial profit as an income flowing to the entrepreneur (explicitly differentiated again from interest on capital) as a return to successful investment decisions (Böhm-Bawerk, 1959, I, pp. 6-7). In his illustration, profit is determined by subtracting the prevailing interest rate from gross profits. Böhm-Bawerk describes all this as the “problem of no small difficulty” of separating entrepreneurial profit from interest, and explicitly avoids further exploring the issue (Böhm-Bawerk, 1959, I, p. 7).

In the second volume, the *Positive Theory of Capital*, Böhm-Bawerk returns to the subject of entrepreneurial profit in more detail, in connection with the law of costs. In this section he more completely defines entrepreneurial profit, which in its simplest form is merely a differential between market prices and costs of production:
If at any time the price does rise considerably above cost, then the production of that article becomes exceptionally profitable for the entrepreneurs. That not only supplies an incentive for them to expand their flourishing establishments, but it also encourages new entrepreneurs to enter this profitable line of business. The quantity of that particular product that is offered on the market is thereby increased, with the ultimate result that, in conformity with the law of supply and demand, the price begins to fall. Conversely, if at any time the market price falls below cost, continuation of the production of the good becomes a losing proposition and consequently the entrepreneurs abandon or restrict its production. (Böhm-Bawerk, 1959, II, p. 248)²

The question as to what causes this differential remains to be answered. It is clear from the quotation that Böhm-Bawerk views entrepreneurs as actively directing production so as to increase or decrease production. Entrepreneurs therefore control the means of production, and furthermore bear the uncertainties of the market, because it is they who reap the benefits of a “flourishing establishment, or who suffer when production “becomes a losing proposition.” The incentive to earn profits (or avoid losses) mentioned in this passage is the driving force which pushes prices in the direction of costs of production, and the direction of production itself. It is apparent that this tendency is a distinctly entrepreneurial problem, to be solved by the careful adjustment of production by those who bear the weight of past errors in judgment regarding the state of the market.

Böhm-Bawerk uses the example of a fictional iron market to clarify his approach to prices and costs, and in doing so, further explores the role of the entrepreneur. In explaining the demand for iron, he implies much about the entrepreneurial function:

Each manufacturer will want to buy just so much iron as he needs for producing such quantity of his commodity as he anticipates he can sell to his own customers… obviously no manufacturer will pay

more for a hundredweight of iron than he can realize from it… in the purchase price that his customers will pay him. (Böhm-Bawerk, 1959, II, p. 249; emphases added)

This passage implies several important ideas regarding the entrepreneurial function. The producer-entrepreneur in this example is buying iron as a higher-order good which will eventually be transformed into a consumer good. The price at the last stage must justify the cost incurred by the producer. But the separation in time of the two prices means that the entrepreneur must speculate about the future state of the market (he must “anticipate” correctly). These speculative judgments play the key role in determining the demand for the factors of production: “the participation in the market demand for iron on the part of each producer depends on his own estimate, and that he derives from the market price of his own special kind of ironware” (Böhm-Bawerk, 1959, II, p. 250; emphasis added). Once again, the “estimate” implies an anticipation of some future state of prices and costs. Entrepreneurial decision-making allocates resources to production, committing them for the specified period. Future prices then determine whether or not the entrepreneur’s earlier estimate were correct, and will result in either entrepreneurial profits or losses.

Given the above analysis, the claim made by Hawley appears somewhat weak. Hawley’s conclusion is that Böhm-Bawerk’s theory of profit cannot be sustained because it does not explain why the entrepreneur does what he does, because: “on the average, the undertaker will get back… just what he has paid to the laborer, the landlord, and the capitalist, plus his own wages of management” (Hawley, 1892). But once we see that profit is not merely wages but a return to a distinct function, this critique collapses, because the average return is not zero, but some uncertain (possibly very great) value, and is not simply a wage. Hawley seems to recognize this last point, observing that for Böhm-Bawerk “the wages of management, although earned by
intellectual rather than physical exertion, are yet wages” (Hawley, 1892; emphasis added). It is not clear why the difference alluded to does not distinguish wages from entrepreneurial decisions, and Böhm-Bawerk makes no such claim; quite the opposite in fact, as I show.

In his discussion of the law of costs, Böhm-Bawerk notes that exceptions to equivalence of price and cost are legion, and he points out two distinct reasons for this. One is of course the phenomenon of interest, with which Böhm-Bawerk’s work is primarily concerned. The second is a category of causes which he describes broadly as “frictional obstacles.”³ Böhm-Bawerk uses this “comprehensive” term to mean anything which prevents factors at different stages of production from being uniformly valued, leading to “asymmetrical deviations in price as between earlier and later stages of production” (Böhm-Bawerk, 1959, II, p. 256). As he puts it,

The stream of the means of production does not maintain uniform breadth on its course toward the final stage where they become consumption goods. Instead… the stream at some points is dammed up and it broadens, while at others it falls and the stream narrows. (Böhm-Bawerk, 1959, II, pp. 255-256)

He goes on to say that,

In actual practice such “frictional obstacles” are infinite in number. There is no moment of time and no branch of production which could boast a complete absence of them. And that is what gives the law of costs its well known character of a law which has only approximate validity and which teams with exceptions. And those numberless big and little exceptions are the inexhaustible source from which flows the constant stream of entrepreneurs’ profit— and of entrepreneurs’ losses as well. (Böhm-Bawerk, 1959, II, p. 256)

This appears to be consistent with Pribram’s claim that this theory attributes profit to “a combination of fortuitous circumstances or to superior ability” (Pribram, 1983, p. 330). Further

³ It is important to note that this type of friction is not the one criticized by Mises (Mises, 2009, pp. 44-47). Mises refers to Böhm-Bawerk’s claim that “frictions” in the economy ensure monetary neutrality.
clarifications are necessary though. Frictions merely make profits possible by driving a wedge between prices and costs of production, a wedge which provides incentives for entrepreneurs to alter their demand for and allocation of capital. Frictions represent opportunities; if entrepreneurs are correct in their speculative judgments and successfully deploy capital goods, they can earn profits (or if they are incorrect, losses). Thus the true source of profits and losses is the entrepreneur, and not the environment, the “fortuitous circumstances,” in which he acts. This is important, because although events might be fortuitous in the sense that they create opportunities, profits are not due to luck *per se*, but to superior judgment. Without resource allocation, no combination of frictions can produce either profits or losses.

Let us try to see this more clearly in Böhm-Bawerk’s writing. Böhm-Bawerk does not elaborate on the specific causes of friction, referring only to “some disturbing cause or other” (Böhm-Bawerk, 1959, II, p. 256). Further remarks make it clear however that he attributes frictions in the production structure to speculative errors on the part of capital owners, whose demand, as we have seen, anticipates the demands of consumers. Böhm-Bawerk is quite clear on this point in a chapter explaining the relation between the price and cost of the factors of production:

The divergence [between price and cost] is of two kinds: some of it [interest] is regular, some of it is random. Both kinds are attributable to the circumstance that production takes time. Often long periods of time will pass during which goods of sixth or eight order pass through all the intermediate stages before being converted into the final form as mature consumption goods. And during that time people and things can change. Wants can alter, so can the relations between want and coverage, and above all, *the insight into those relations can change.* Naturally the estimates of the value of the goods in the various stages of their progress toward maturity will change correspondingly. It can readily be seen that the fluctuations which
arise from that source may be extreme or slight, may be upwards or downwards. They are deviations that know no rule. (Böhm-Bawerk, 1959, II, p. 172; emphasis added)

In other words, time introduces uncertainty into the data of the market. This in turn necessitates correct judgments on the part of the entrepreneur in order for production to coincide with future demand. The element of randomness ("friction") refers to changes in the tastes of consumers, which of course are inextricably linked with the problem of time. In this sense, the potential to profit is a random occurrence to the entrepreneurs, who do not which way the preferences of consumers will change. Actually reaping profits is, in Böhm-Bawerk’s view, the result of prescient production decisions by the owners of capital goods who foresee these changes through the fog of Knightian uncertainty. Böhm-Bawerk explicitly singles out the entrepreneur’s perception of the state of the market data (the relation of goods and scarcity to consumer demand) — his “insight” — as the most important implication of uncertainty. This perception is in fact the primary source for Böhm-Bawerk of the value differential which results in entrepreneurial profits and losses.

As a way of rounding out the discussion, let us briefly mention the place of Böhm-Bawerk’s theory in the history of economic thought. It is clear that Böhm-Bawerk anticipated and influenced the theories of Ludwig von Mises and, perhaps ironically, Frank Knight (Hébert and Link, 1998, p. 69). It is not surprising though that Knight did not to see similarities between

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4 Böhm-Bawerk wrote before Knight introduced the distinction between quantifiable risk and unquantifiable, “true” uncertainty (Knight, 1993 [1921]). However, it is obvious from Böhm-Bawerk’s discussion (and also Fetter’s) of time in the context of profit that he refers to the latter. As one example, consider the discussion below of “random” changes in the market data over time.

5 Schumpeter described this as “a friction or uncertainty theory, whichever the reader prefers: the source of entrepreneurs’ profits was the fact that things do not work out as planned, and the persistence of positive profits in a firm was due to better-than-normal judgment.” He goes on to claim that “the obvious common sense of this explanation may easily cover up its inadequacy” (Schumpeter, 1954, p. 893). This point is not clearly explained, but he appears to mean that Böhm-Bawerk adopted too much of a classical theory of profit. Cf. Schumpeter (1954, pp. 893-898).
his own work and that of Böhm-Bawerk. Knight, for example, denied that Carl Menger
developed a theory of the entrepreneur, and makes only a slight reference to Böhm-Bawerk
(Knight, 1950), despite the fact that his own theory is close to that of Menger and the Austrians
in general (Martin, 1979; Schumpeter, 1989 [1951], p. 257). Of his rough contemporaries
however, Böhm-Bawerk’s approach most closely resembles that of Frank Fetter (1915).
Although Böhm-Bawerk was anticipated by Richard Cantillon and Frédéric Bastiat (among
others), I mention Fetter specifically because his work is also typically neglected in the
literature. Fetter’s theory is described briefly in Salerno (2008) but it is worthwhile to more fully
explore it.

**Fetter on the Theory of Profit and Entrepreneurship**

I. **The Meaning of Profits**

The significance of Fetter’s theory is found in its clarity and thorough attention to detail
in separating the entrepreneur’s (Fetter uses the term “enterpriser”) function from other
economic functions. Fetter’s principal writings on entrepreneurship and profit are found in his
*Economic Principles* (1915), although his earlier textbook (1910) makes many similar points, but
in far less detail. At the time, *Economic Principles* was recognized as an extension and
refinement of the theoretical apparatus of the older “Austrian” school, in particular of the theory
of value developed by Menger, Böhm-Bawerk, and von Wieser (Whitaker, 1916). In this context
especially, Fetter’s contributions attain greater significance, given both Böhm-Bawerk’s
relatively limited treatment of the subject (McCaffrey and Salerno, 2012) and the importance of
entrepreneurial theory for the younger Austrian school (e.g. Mises, 1998; Kirzner, 1973).

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6 The tradition stemming from Cantillon is discussed in Hébert and Link (1988) and Hébert (1985). The latter source elaborates on Cantillon’s connection to the Austrian school specifically. Salerno (2008) surveys several economists in the tradition from Menger onward.
Fetter’s theory of the entrepreneur begins with the simple observation that the factors of production must be combined. Scarcity dictates that labor and capital must be either increased or advantageously combined to meet human demands, and this necessitates “active intervention” in the arrangement of the factors, which is the essence of entrepreneurship (1915, pp. 317-318). The combination of factors gives rise to the different branches of income, which can be divided into two broad categories, “contractual” and “non-contractual.” All ordinary wages and rents fall under contractual incomes, whereas non-contractual incomes are reserved for certain capitalists. Capitalists are of two sorts, active and passive. Passive capitalists also receive a contractual income, namely interest payments, from the active capitalists, who are the entrepreneurs in Fetter’s system (1915, pp. 318-321). It is common that certain individuals, especially self-employed persons, are simultaneously wage earners as well as active and passive capitalists. The functional distinction only becomes easily discernable with the emergence of the firm and the intensification of the division of labor within industry (1915, pp. 319-322).

The non-contractual income of the entrepreneur is a residual income. However, Fetter is quick to dispel misunderstandings from the use of this term:

[I]t must not be thought that all the other contractual shares (wages, rents, etc.) are determined prior to, and independent of, this share of the active capitalist, who takes what is left without having had any choice in the matter. That would be so if he could do nothing whatever about readjusting and rearranging his investments. The various contractual incomes are determined in an economic equilibrium of which the prospect of active capitalists getting a more or less definitely estimated minimum return is an essential part. The expectation of income has guided the enterpriser’s choice of a business just as it guides the laborers… For this particular year and business this kind of share is an arithmetic residual, but year in and year out it is as much subject to adjustment by investors’ valuations as is any other share. (1915, pp. 321n1; emphasis in original)
This passage anticipates many of the elements about to be explored in Fetter’s argument: uncertainty, expectations, decision-making, and so on. The major point however, is that residual income is not an arbitrary return to the entrepreneur, but is to some extent determined along with other factors: in other words, it is not a residual in the strict sense of the term. Also, in practical economic affairs the residual coincides with the other branches of income, and it is only for particular accounting periods that it may be considered the remaining share (also, 1915, pp. 343-344). The distinction between contractual and residual income is also found in the work of Frank Knight, who also argued that profit is the non-contractual residual income share. Knight also pointed out the difficulty in identifying “pure” forms of any of the streams of income in actual business affairs (Knight, 1933 [1921], pp. 271-272).

A major problem for theorists, according to Fetter, is to separate the practical definition of the term profit from its technical, economic meaning. The latter is termed “pure profit,” and is “the income of the active capitalist as such, attributable solely to the active capital-investment in the particular enterprise” (1915, p. 344; emphasis in original). Profit is an excess over the prevailing market rate of interest, which secures income “by itself...or with a negligible amount of judgment and supervision” (1915, p. 345). Profit is therefore both distinct from interest and a return to a specific function, namely the “element of investing management together with the carrying of the financial risk” (1915, p. 345). This entrepreneurial profit thus possesses a “dual character”: it is capital income and labor income, combined in the person of the entrepreneur.

II. The Essence of Enterprise

After this preliminary discussion of the entrepreneur, and of the type of income which must be explained by entrepreneurial theory, Fetter proceeds to the heart of the problem. The
question is: what sort of economic behavior—what economic function—is capable of yielding the residual income called “profit” (alternatively, “loss”)? For Fetter, “the peculiar function of enterprise is investment and ownership… The owner of a fund of purchasing power can not leave it to invest itself” (1915, pp. 326-327). The entrepreneur is thus the owner of capital, who exercises decision-making power over a range of possible investment choices which cannot be made mechanically.

These choices can be either many or few. Further, they may be either intimately involved in actual production or be quite removed from the physical production process: “The primary function of enterprise is the choice of a business in which to invest; the next, and essentially last function, is to provide competent management” (1915, p. 327). The essence of management concerns the “ordinary” direction of the productive process. As owner of the enterprise, the entrepreneur can delegate any number of tasks to managers, but the one task which can never be completely eliminated is the choice of the managers themselves (1915, p. 323). In smaller enterprises the entrepreneur may remain a manager, but the two functions are distinct in theory, even if in practice the income streams accrue to the entrepreneur together (1915, p. 326). The power of decision-making regarding which individuals will actually make the everyday, practical decisions of business operations is the “residual” function of the owner-entrepreneur. This is much the same distinction between entrepreneurs and managers drawn by Ludwig von Mises, who points out that whatever the nominal relation between entrepreneur and manager, the true line is drawn by the fact that the manager is ultimately beholden to the decisions of a higher authority (Mises, 1998, p. 301).

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7 As mentioned above, many of the points examined in this section appear in embryonic form in Fetter (1910, pp. 282-291).
Within Fetter’s broad class of managers are the promoters, those managers who excel in devising new opportunities and raising capital to exploit them; the “moving spirits” whose talents in planning are employed by the owner-entrepreneurs, as opposed to engaging in typical managerial decisions (1915, p. 334). It is the entrepreneurs however, who manage the managers and promoters, and maintain ultimate control over their activities. This “final management” comprises the “active” portion of the function of entrepreneurship.

More explicitly, the entrepreneur must evaluate production decisions and guide the production process through the selection of superior managers (1915, 327-342). This involves all decisions about the marginal employment of the factors of production:

The enterpriser must constantly study the question whether the application of another unit of any one factor at the price will, following the principle of proportionality, add to the value of the product as much or more than the cost. This calculation is made for every one of the minor factors entering into the business, and for the business as a whole. The proper proportion varies at different prices, or costs…

[T]here is a constant substitution of the various materials. The right proportions change constantly with inventions. (1915, pp. 340-341)

The “minor factors” are the particular production inputs which must be chosen so as to optimize output, while “business as a whole” refers to the broader choice of production functions, which are not simply given from the perspective of the entrepreneur (although they are given for managers). These two tasks require the careful judgment of the entrepreneur in allocating resources to production.

Fetter goes on to emphasize the importance of the uncertainty of business conditions for these entrepreneurial judgments. He argues, following the line of reasoning above, that entrepreneurial decisions must change frequently, because changing business conditions alter the
costs of all inputs, and even of production itself, thus making continuous adjustments necessary to maintain profit margins (1915, pp. 340-342). Uncertainty will be discussed in more detail below, but suffice it to say for the moment that time and the unpredictability of economic conditions are a vital piece of the entrepreneurial puzzle. Whitaker (1916) comments that Fetter’s system takes little account of the passage of time, but Fetter’s theory of the entrepreneur seems to show that this claim is unwarranted, at least in this respect. In fact, time is the key element in enterprise, because it gives rise to uncertainty, which in turn makes entrepreneurship both possible and necessary. The entrepreneur’s careful adjustment of production to changing conditions makes sense only in the context of time and changing conditions.

III. Risk and Uncertainty

This section attempts to show that Fetter’s analysis partially anticipates Knight’s distinction between “risk” and “uncertainty.” In order to best demonstrate this, it should be shown that Fetter regards entrepreneurship as a matter of so-called “true” uncertainty, and not one of simply taking risks. This distinction is first made in Knight’s Risk, Uncertainty, and Profit (1921), which has played a prominent role in emphasizing true uncertainty in the entrepreneurial literature. Knight’s contribution is well known, and needs only a cursory mention. Broadly speaking, risk is easily quantifiable and may be expressed in terms of clearly-defined probabilities. Uncertainty, on the other hand, is difficult or impossible to describe in such clear-cut terms, as the events it describes are highly heterogeneous (Foss and Klein, 2012). It is dealing with the latter, according to Knight, which characterizes entrepreneurial decision-making. Fetter does not use the terms “risk” and “uncertainty” to make Knight’s distinction in regard to judgment, and perhaps this is why he is not discussed in Knight’s treatment of his
predecessors (Knight, 1933 [1921], pp. 22-48). Nevertheless, Fetter does implicitly address aspects of Knight’s theory.

At first glance, reconciling Fetter and Knight appears difficult because Fetter routinely uses the term “risk” to describe entrepreneurial judgments. However, Fetter does not mean risk to indicate homogeneous types of events, or in the quantifiable sense of known or knowable probabilities of outcomes. Rather, his meaning incorporates several finer distinctions, including some similar to “uncertainty” in the Knightian sense. Fetter’s discussion of these issue takes place mostly within a chapter of *Economic Principles* titled “Various Shades of Profits,” wherein he attempts to catalogue the various conditions which influence the emergence of profit and loss. Fetter is quick to point out that “There are many chances and risks [in business], but few of them are completely objective, of a kind utterly beyond the control of the enterpriser” (1915, p. 359).

There are thus several types of chance which play a role in profit-making activity, some not involving the entrepreneur. But how exactly are the lines between different sorts of chance drawn? Fetter’s answer bears some similarity to Knight’s, and also involves distinctions about classes of future events, their insurability, and the problem of judgment in dealing with them. To begin, Fetter provides an example of how entrepreneurs differ from simple risk-bearers:

The risk of business is not that of the throwing of dice in which (if it is fair) skill plays no part and gains in the long run offset losses. Business risk is rather that of the rope-walker in crossing Niagara; the task is easily undertaken by the skilful Blondin, it is fatally dangerous to the man of unsteady nerve and limb. (1915, p. 359)\(^8\)

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\(^8\) This example avoids an objection advanced by Hawley (1892) against Böhm-Bawerk’s theory, which is relevant because it is similar to Fetter’s. Hawley argues that entrepreneurial activity cannot be explained by any theory which holds that losses and gains balance in the long run, because no incentive for entrepreneurs to undertake production exists. Fetter’s point is that there is no such balance in entrepreneurial affairs.
In this case, personal skill and intuition are used to deal with non-measurable risks. Fetter’s point is that the entrepreneur’s problem is not one of simply gauging well-defined probabilities— as in the case of games of chance— but of behavior in situations where any such probabilities are nonexistent from the perspective of the individual. As the example of the tightrope walker indicates, individual aptitude and insight are the key ingredients in dealing with this type of non-quantifiable risk.

The difference between risk and uncertainty is clearer in Fetter’s discussion of the factors which influence successful entrepreneurial judgment, one of the most important of which is luck. Fetter argues that whenever chance appears beside deliberate choice, chance usually plays a relatively small role, because “The more causes of success in general are studied, the larger is found the element of choice, the smaller that of luck” (1915, p. 360). “Pure chance,” however, does play some role in determining profits. In these discussions, Fetter uses “chance” and “luck” interchangeably, and carefully distinguishes between these (uncertain) events and other (risky) possibilities:

What is luck? A result that is not calculable, coming to pass in conditions where a rational choice is not possible, is called luck, for lack of another name… According to the law of chance, in the tossing of a coin for “heads or tails,” one side is as likely to come up as the other, and in the long run the number of heads and tails will be equal. Taking all together the pure accidents of certain kinds, in the community, they are so numerous that losses and gains distribute themselves about a general average by what is called the law of averages, or the law of large numbers. The individual’s risk then may be eliminated by insurance… But many factors evade all attempts to reduce them to rule and there is no possibility of insuring against them: war, changes in markets, good and bad harvests, financial crises, etc. (1915, pp. 360-361)

There is in explicit distinction then between events which are insurable and those which are not, which is an important implication of Knight’s distinction. Fetter’s approach is different
than Knight’s though, in the sense that for Knight, uninsurable events must be dealt with according to entrepreneurial judgment, whereas for Fetter, some uninsurable events are simply a matter of luck. “Luck” in Fetter’s sense is a more extreme category than Knightian uncertainty, because while both relate to unknown outcomes which cannot be clearly defined, Fetter argues that wars, market aberrations, bad harvests, and crises are outside the scope of entrepreneurial decision-making. As he summarizes things, “One man makes a success because he happened to engage in business at that time, another man fails because he happened to undertake it at another time, with no more real judgment in the one case than in the other” (1915, p. 361). Therefore some (not all) events which determine the existence of profits (seemingly, those events most closely resembling Knightian uncertainty) occur simply due to luck, and not to entrepreneurial skill.9

But not all events which are uninsurable are non-entrepreneurial. Fetter also describes entrepreneurs as relieving laborers and capitalists of the uncertainty involved in their employments, in other words, from unforeseen, potentially damaging, fluctuations in price (1915, pp. 364-365). This specialization in risk-taking is a form of insurance to those whose income is thereby rendered more certain. But its significance for entrepreneurs is different: “The cautious businessman tries to reduce chance as much as possible by insurance, where a regular system prevails, and to confine his thought and worry to the parts of the productive process where his ability counts in the result” (1915, p. 365). In this passage, entrepreneurial decision-making clearly takes place in the context of uninsurable events, where ability “counts.” The implication is that entrepreneurial judgments can deal with some, but not all types of Knightian

9 Fetter also mentions dishonesty and fraud as possible sources of profit (Fetter, 1915, pp. 367-367), but these are nonmarket behaviors, and therefore fall outside the traditional scope of theories of entrepreneurship and economic profit. The result is that the types of profit reduce to those involving exceptional decision making in the face of genuine uncertainty, and to a lesser extent, pure luck.
uncertainty, although as I discuss throughout this section, Fetter’s exact position on risk vs. uncertainty, insurable vs. non-insurable events, and entrepreneurial judgment vs. luck is somewhat blurry.

Fetter again comes close to Knight when describing risk as a sort of spectrum, with one end representing easily quantifiable, insurable events, and the other hard-to-quantify, non-insurable events. “Risk is more or less everywhere in human affairs, but among various kinds of investments there is a well-recognized gradation in the uncertainty of returns. The enterpriser in a business takes the more exposed frontier of risk” (1915, p. 347; emphasis added). Fetter goes on to mention the risk in various sources of income to enterprise: bonds, common stock, and dividends (in that order). The returns to each are based on their respective risk, in relation both to their stated market return and the solvency of the firm (its legal liabilities). And all contain an element of risk greater than investments in government bonds, which are essentially riskless. The above investments are relatively passive however, whereas the entrepreneur is an active investor. The point is that the entrepreneur is at the “frontier”; the most risky type of investment. The implication—in these passages and throughout Economic Principles—is that Fetter does risk as more than a homogeneous category, but views distinctions within it as between points on a spectrum, as opposed to “pure” cases of risk or uncertainty. And at one end of this spectrum are events which must be dealt with using a special sort of decision-making, i.e. entrepreneurial judgment.

Fetter proceeds to clarify the relation of the passive to the active investors (entrepreneurs):

Every enterprise, however simple, involves ownership of agents and product, and between the investing and the accounting at the end of any period, there is financial responsibility and profit or loss.
This may be minimized by one owner by contract with another, the one thus becoming more passive and safe, tho still having some risk, and the other, taking at a price the active control of wealth and services and selling the results for whatever he can get. (1915, p. 358)

The passive investor then may contract in order to reduce his liability to a share of the risk. Essentially, he may insure himself because a well-defined risk may be treated as a fixed cost. The active investor however, assumes the “risk” relinquished by the passive investor. He sells for “whatever he can get”; an ill-defined result based upon uncertainties in the market data and the entrepreneur’s ability to surpass them (and possibly an element of pure luck as well). Not only the passive investor, but also the decisions of laborers (receiving wages) involve risk, because judgment of the future is required in these cases as well (1915, p. 358). But their income is largely “definite,” contractual. Only the actively-investing entrepreneur receives the residual, non-contractual income termed “profit.”

The above discussions show that the essence of Fetter’s distinction between active and passive investors, between contractual and non-contractual incomes, fixed and residual payments, is that there is something which makes decision-making in the latter categories different. There is some type of judgment about the future which is not and cannot be shared by others who are not active, non-contractual residual claimants. The distinction Fetter was reaching for, I argue, is that between risk and uncertainty developed almost simultaneously by Frank Knight. For Fetter, the entrepreneur deals with choices which are more than simple risks, but are not fully Knightian uncertainties. A full exploration of the possible similarities between Fetter and Knight falls outside the scope of this paper. Suffice it to say that Fetter appears to have anticipated to a small extent Knight’s analysis of the role of uncertainty in entrepreneurial decision-making.
IV. Judgment and the Entrepreneurial Personality

The last piece of Fetter’s theory regards the decision-making process of the entrepreneur, that is, the problem of judgment. Many of the major points on this theme have already been made above: here, I will add only a few details. As mentioned previously, it is not the existence of uncertainty as such which generates profits. Rather, “profits are seen to be due not to the existence of risks, but to *comparative skill in taking risks*… [P]rofits in the long run are the share (non-contractual) of skill and ability in the function of enterprise” (1915, p. 359; emphasis added). Furthermore, a great part of this skill is the ability to search out opportunities, to know where to look: “Throughout life there is constant opportunity, but it must be sought. One who has the good judgment to be ever at the right time at the place where he has the best chance of finding a good thing, usually gets the advantage, and men call it luck” (Fetter, 1915, p. 360). Personal prescience regarding the future movements of market forces— and acting based on it—is therefore an essential part of entrepreneurial judgment.

The entrepreneur also deploys “superior knowledge and superior insight” (Fetter, 1977, p. 244), but this description by itself is rather broad. The example of Blondin on the tightrope, for instance, implies immense personal skill that is not easily transferable. Specifically, continued success in performing the entrepreneurial function depends on the personal qualities of “vigilance, strength, and self-assertion” (1915, p. 349). Fetter also describes the entrepreneur as “the man who can see most quickly and clearly,” to some extent evoking the image of the alert entrepreneur later espoused by Israel Kirzner (1973, 1979).10

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10 There are several important differences between the two theorists however. Fetter views the entrepreneur as the owner of resources, whereas Kirzner sees entrepreneurship as resource-less. More importantly, Fetter often views the discovery of profitable opportunities as being the result of careful search, whereas for Kirzner search is completely distinct from entrepreneurial alertness.
It is clear then that judgment is intimately tied up with the personality of the entrepreneur, depending as it does on skills which are uncommon. And although Fetter employs a functional theory of entrepreneurship, he does discuss the personal qualities of successful entrepreneurs. In fact, the problems of judgment and prescience in decision-making lead naturally to a discussion of such personal characteristics, because personality will often influence judgment. Fetter is less prone to identify personal characteristics as being vital to the entrepreneurial function than were his contemporaries in the field, such as Schumpeter (1942) and Wieser (1927, p. 327). Nevertheless, he does mention in passing the traits which tend to accompany the function of “active investment” and successful judgment, and weaves them into his broader theory of enterprise.

V. Fetter’s Critique of Davenport

One possible reason that Fetter is not usually discussed in the entrepreneurial literature is that he was highly critical of Herbert Davenport’s *The Economics of Enterprise* (1913), which emphasized the importance of entrepreneurial activity in the market economy. In fact, Davenport essentially defined economics as the study of entrepreneurial activity (Davenport, 1913, pp. 19-27). As mentioned above, one of the few places Fetter appears in the history of entrepreneurial theory is in reference to his criticism of Davenport (Hébert and Link, 1988, pp. 90-93). Fetter wrote a lengthy review of *The Economics of Enterprise*, attacking it in several respects, from Davenport’s theory of banking down to his bibliography (Fetter, 1914). But Fetter largely avoided Davenport’s theory of entrepreneurship, focusing instead on issues relating to the theory of interest. The explanation for this lack of attention provided by commentators is that Fetter simply did not appreciate Davenport’s originality in laying out economic theory from a distinctly
entrepreneurial point of view (Hébert and Link, 1988, pp. 90-91). This understanding is reinforced by the fact that Fetter criticizes Davenport for a general lack of originality.

Also noteworthy is Fetter’s dismissal of Davenport’s definition of economics, which reduced it to “the realm of exchange in a money economy, that is, to a régime of monetary price [entrepreneurial competition]” (Fetter, 1914). Given this criticism especially, it is plausible that Fetter did not notice anything particularly useful in Davenport’s view of entrepreneurship. This interpretation would be supported by the title of Fetter’s essay, “Davenport’s Competitive Economics,” which acknowledges the importance Davenports assigns to the entrepreneur: the reference is apparently to Davenport’s claim that the starting point of economic analysis is “society organized under competitive entrepreneur production” (Hébert and Link, 1988, pp. 90-91). When combined with Fetter’s claim that Davenport fails to accurately define economics, this does seem to imply that for Fetter, something is amiss with Davenport’s entrepreneurial view of economics.

On the other hand, Fetter sometimes appears to believe that Davenport’s writing does not extend his entrepreneurial theory enough. Credence to this interpretation is once again supplied by Fetter, in his criticism of Davenport’s use of “immoral” examples to illustrate basic economic principles:

The theme running through the book that variations in terms of private capital do not necessarily reflect production in a social sense—a truth often recognized—still needs occasional repetition. It certainly is repeated here: Peruna, as an example of harmful yet valued products, is administered in large doses; and burglars with their jimmies, and loose women with their flaunting appeals, appear often that they make some chapters of this book appear like an evening at the uncensored movies. It would have been well if the author had proceeded more cautiously in extending this notion of predation and exploitation to
the whole field of competitive economics— which, by definition, is the only kind he recognizes. (Fetter, 1914)

In Fetter’s eyes, Davenport’s examples reveal that he has largely abandoned his competitive approach, choosing instead to focus on somewhat bizarre behaviors to make his point, whereas the application of basic principles to more mundane business conditions would have revealed the definition of economics as price competition to be faulty. This criticism of what is undoubtedly a thoroughly entrepreneurial view of economics may explain Fetter’s neglect by historians of entrepreneurship. And whatever the exact reason for his rejection of Davenport’s arguments, it should be clear from the discussions throughout this paper that Fetter does recognize the importance of entrepreneurial theory, and furthermore, that his theory is worthy of discussion in the historical literature.

In painting a picture of the entrepreneur as a capital-owning, decision-making bearer of market uncertainty, Fetter is not alone in the history of economic thought. There is a long line of theorists linking the entrepreneur (and profit and loss) to uncertainty-bearing. The tradition begins with Richard Cantillon (2010 [1755]), and includes, among others, Eugen von Böhm-Bawerk (1959), Frank Knight (1933 [1921]), and Ludwig von Mises (1998 [1949]). Fetter’s place in this larger tradition is discussed in Salerno (2008), who, like Fetter’s contemporaries, points out his relevance for the “Austrian” tradition in economics. Specifically, Fetter fills a gap between the older Austrian school (Menger, Böhm-Bawerk, and Wieser) and the younger school of Mises and Hayek.

Conclusion

Both Böhm-Bawerk and Fetter are important figures in the history of economic thought, and within the Austrian school in particular. However, their writings have been largely neglected
in the literature on entrepreneurial theory, a fact which this paper hopes to rectify. This paper endeavors to show, in part following Salerno (2008), that an unbroken line of reasoning about the entrepreneur exists in the Austrian school from the older to the younger generations, and which can reasonably be described as the “Austrian” theory of entrepreneurship and profit and loss.

Building on the tradition founded by Carl Menger, Böhm-Bawerk argued that profit and interest are distinct categories of income, and that profit is a return to entrepreneurs who successfully deploy capital in time-consuming production. Likewise, Frank Fetter’s work of the theory of entrepreneurship has also been neglected by historians of thought. Fetter, however, takes great pains to elaborate a complete theory of the entrepreneur and profit and loss, further adding to the mystery of his absence from the literature. I argue though that part of the explanation for this lack of attention is Fetter’s dispute with Davenport. In addition to echoing Böhm-Bawerk’s theory—emphasizing entrepreneurial judgment in the face of uncertainty, and the owning of capital resulting in uncertainty-bearing—Fetter also provides an early version of Knight’s distinction between risk and uncertainty, and highlights the importance of the latter for entrepreneurs as a source of profit and loss.
References


