



Dialogue

Is Effectuation Lachmannian? A Response to Chiles, Bluedorn, and Gupta (2007)

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Introduction

In an excellent recent paper on Ludwig Lachmann's contributions to entrepreneurship, Chiles, Bluedorn and Gupta draw parallels between Lachmann's work and later contributions in the entrepreneurship literature, including Sarasvathy (2001), suggesting that, 'Sarasvathy's economic approach to entrepreneurship is decidedly Lachmannian' (Chiles et al. 2007: 487).

Our purpose in responding to the Chiles et al. article is twofold. First, our interpretation about how effectuation works differs in certain ways from the interpretations placed on it by these authors; we therefore wish to clarify our views on these matters. Second, we view the relationship between effectuation and Lachmann's perspective on entrepreneurship somewhat differently than Chiles et al.; in this note we lay out this alternative view. The crux of our presentation is that, although Lachmann and Sarasvathy have much the same starting point (entrepreneurial action in the face of true uncertainty) and several overlaps in terms of the overall implications for dominant economic theories, there are crucial differences that draw upon recent developments in our understanding of how the human mind works and what knowledge is constituted of. In particular, there are at least three areas of possible conceptual confusion:

The problem of knowledge — or What do we take as impossible? Strategies.

The problem of resources — or What do we take as given? Players.

The problem of institutions — or What do we take as outside our control? Rules.

The Problem of Knowledge — or What do we take as impossible? Strategies

One of the most important contributions Lachmann made to Austrian economic theorizing concerned the need to take expectations as subjective and therefore

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Organization
Studies
29(02): 239–245
ISSN 0170–8406
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SAGE Publications
(Los Angeles,
London, New Delhi
and Singapore)

primitive to economic analyses — the same way that mainstream economists take tastes, preferences, and wants as data. In other words, expectations are not derivable endogenously through the economic processing of other primitives. In this, Lachmann (1943) explicitly made a clear departure from Austrians such as Schumpeter and even Hayek, who struggled with explaining expectations with a view to modeling the market process as an instrument for the convergence of expectations. Instead, radical subjectivists urge taking expectations as *sui generis* and divergent across individuals. Before Shackle enjoined the battle in 1939 and ‘extended the scope of subjectivism from tastes to expectations’, Lachmann (1976: 58) argued, expectations ‘were, on the whole, treated as a mode of foresight’ rather than an act of pure creativity and imagination.

But what are expectations in the Lachmannian sense? How are they different from predictive inferences drawn by economic agents’ behavior? And what does it mean to say expectations are subjective and hence heterogeneous across individuals? There appears considerable confusion on this front and Chiles et al. (2007) reflects that in the following excerpt:

‘For Lachmann, entrepreneurs create *ex nihilo*, through what Ford (2002: 641) calls the forward-looking process of imagining that allows them to “think outside the box”, where the “box” is defined largely by the limits of knowledge rooted in interpretations of the past. (This was Albert Einstein’s point in saying, “Imagination is more important than knowledge,” and Wayne Gretzky’s in stating, “I skate to where the puck is going to be, not to where it has been.”) These ideas are especially congenial with work on effectuation (Sarasvathy 2001a,b).’ (Chiles et al. 2007: 473)

Is Einstein’s conception of ‘imagination’ the same as Gretzky’s prescription for ice hockey? And is either of these the same as the non-predictive logic central to effectuation? In our view, it is imperative we spend some time carefully unpacking these concepts. One way to do this would be to ask ourselves, ‘How exactly does one do any of these three things?’ Let us begin with ‘skating to where the puck is going to be’ — clearly, this involves predictions based on hours and hours of practice. Knowledge of how pucks move on ice and what moves other players are likely to make are both essential inputs into predicting where the puck is going to be. Granted that, even with the same data on these two fronts, each individual player may come up with a different expectation as to where the puck will be. The important point here is that the player himself does not have control over where the puck is going to be.

Similarly, Einstein’s imagination had to do with creativity in the context of scientific discovery; it did not involve strategies of non-predictive control. Einstein scholars have pointed out that he was not always consistent in his explanations or even his understanding of his own creative processes. Yet, as Stachel (1983) explains, although puzzling, the creative process at the heart of Einstein’s discoveries is not beyond all conjecture.¹ He quotes Einstein in this regard:

‘A new idea comes suddenly and in a rather intuitive way. That means it is not reached by conscious logical conclusions. But, thinking it through afterwards, you can always discover the reasons which have led you unconsciously to your guess and you will find a logical way to justify it. Intuition is nothing but the outcome of earlier intellectual experience.’ Stachel (1983: 96)

This crucial point is echoed in Simon's (1985) explanations of creativity based on dozens of studies of novelty generation processes involved in scientific discovery — studies spanning the spectrum from Kepler and Faraday to undergraduates in freshmen physics classes.

Effectuation too builds on prior knowledge and experience and entails acts of imagination as well. But unlike Gretzky's prescription that involves predictive information about the world and other players, and also unlike Einstein's imagination that requires an individual leap of creative intuition, effectuation calls for an intersubjective process using non-predictive information to act upon things within the effectuators' control (See Sarasvathy and Dew 2005 for a detailed exposition of how exactly this happens). In the effectual ice hockey game, the other players openly signal and even commit to where they will move next, taking the guessing out of the game, as it were; and the entrepreneur's imagination becomes more that of an accomplished choreographer than that of a solo scientist or a speculative hockey player. An imaginative choreographer inspires the best performance each member of her company is capable of, and does not need to predict the same. Yet, her imagination cannot entirely assume a Lachmannian world that 'consists not of facts but of our interpretation of the facts' (Lachmann 1977 [1943]: 68) For example, she cannot imagine anything she pleases, for she has to take into account the hard physical constraints of the dance floor as well as the time allotted for the performance. Spatial and temporal realities are not easily ignored even in an imaginative construction of valuable new possibilities.

The information basis for effectuation involves a series of negotiations both between players and within players' own preferences and expectations, some of which may be articulated and inflexible, and others ambiguous and malleable, all occurring within a physical reality of stubborn facts jostling with those open to interpretation. It is only the peculiar structure of a world in which some things are known or taken as given, and others unknown and deemed transformable, that allows negotiations, deal-making and the co-creation of valuable new product-market hierarchies of the kind that Menger, Lachmann and Chiles et al. (2007: 481) so convincingly point to. If all expectations were always known and clearly delineable *ex ante*, as in neoclassical economics, no trade and definitely no new market creation would be necessary; and if expectations were always subjective, divergent and in a continual state of flux, as Shackle and Lachmann would have it, new market creation would be impossible.

Similar arguments can be made in the case of resources and institutions at each node of effectual action.

The Problem of Resources — or What do we take as given? Players

Another notion of considerable importance that Lachmann brings to the table is the one about 'plans' — a concept worth belabouring, especially since it may be easily confused with more recent literatures having to do with business plans and

the planning versus learning debates in strategic management. For Lachmann, plans are not articulated documents guiding strategy making. They encapsulate instead a cognitive construct that helps bring in purposeful human action into the economic process. It would be worthwhile to go to the source here:

'All human action is directed towards purposes. Hence, as Professor Knight has repeatedly reminded us in recent years, all human activity is problem-solving. Man, before setting out his course of action, has to make a plan embodying the means at his disposal and the obstacles he is likely to encounter, otherwise his action is not (rational) conduct but (non-rational) mere behavior. Before starting on his way he tries to chart the path leading to the achievement of his purpose in the topography of his mind. If we say that we wish to "explain" an action, what we mean is not merely that we wish to know its purpose, but also that we wish to see the plan behind the action. Plan, a product of the mind, is both the common denominator of all human action and its mental pattern, and it is by reducing "action" to "plan" that we "understand" the actions of individuals.' (Lachmann 1977 [1943]: 68–69)

This is more evocative of Einstein's assertion about intuition — not that individuals act according to plans, but that even when they may not overtly be doing so, their actions will be explainable in terms of plans — just as the sudden insight of a creative mind can be explained in terms of its antecedents in intellectual experience.

Moreover, in line with Mises and Shackle, Lachmannian plans provide the means–ends frameworks for human action: 'In each plan means and ends are riveted by choice. In a world of change plans have to be revised, but such revision is also always a matter of choice of ends and means' (Lachmann 1976: 4–57); and, as Chiles et al. (2007: 474) point out: 'The capital structure is traceable to the plans and, hence, the subjective knowledge and expectations of individual entrepreneurs, who construct capital equipment capable of yielding future returns.'

Lachmann's capital theory has a lot more in common with the use of resources and means–ends frameworks in effectual logic than either Chiles et al. (2007: 477) or other economists such as Foss et al. (2007: 13) acknowledge. The root of this confusion appears to be simple: both Chiles et al. and Foss et al. confuse the assets that entrepreneurs act on — i.e. what they have — with what Sarasvathy (2001) defines as the entrepreneurs' primary resources or means — namely, who they are (tastes, traits, abilities), what they know (education, experience-based and other types of prior knowledge), and whom they know (social and professional networks). Capital assets in effectuation are artifacts created through the actions of entrepreneurs, and therefore a function of the entrepreneur's means. In other words, what any given entrepreneur sees as the valuable possibilities inherent in any given asset depends on who he or she is, what he or she knows and whom he or she knows. Furthermore, since effectual entrepreneurs often do not know and need not imagine the particular new artifacts that they actually end up creating, there is no assumption whatever in effectuation as to the 'given' nature of capital assets.

Here Lachmann's eloquent articulation of means and ends as 'riveted by choice' is an apt description of the effectuator's starting point, not only with regard to resources, but also in reference to knowledge and institutions. In each

of the three problems being discussed in this note, effectual entrepreneurs rivet by conscious choice certain types of knowledge, resources, and institutions as provisional fixed points while they use others as degrees of freedom to manipulate as they see fit, in conjunction with like-minded stakeholders who self-select into the creation process. This is perhaps most valid in the case of institutions.

The Problem of Institutions — or What do we take as outside our control? Rules

Chiles et al. (2007: 479) describe Lachmann's conception of institutions as follows:

“Institutions”, as Lachmann put it, “enable ... coordinating the actions of millions whom they relieve of the need to acquire and digest detailed knowledge about others and form detailed expectations about their future action” (1970: 49–50). By coordinating the plans of myriad entrepreneurs to a common signpost, institutions provide a degree of order in an otherwise largely undetermined world.’

Furthermore,

‘New institutions arise in deliberate and emergent ways: through legislation or as the unintended consequence of individuals acting in their own interest without any overall design (Lachmann 1970). In either case, Lachmannian entrepreneurs play an important and active role in the creation and subsequent evolution of institutions. Indeed, far from merely reacting to “changing circumstances”, they are the driving force behind institutional emergence and change.’ (Lachmann 1970: 79).

Effectual logic provides a systematic method for entrepreneurs seeking to transform existing institutions into new ones. But, even here, actors have to choose which institutions they will take as fixed and immutable and which they will deem flexible and capable of being reshaped or replaced. Effectual logic therefore provides criteria that guide the ‘riveting’ process of choosing what to take as fixed and further furnishes specific mechanisms for carrying out changes on what is deemed flexible. In other words, effectual logic allows entrepreneurs to live and thrive in a Lachmannian world of divergent expectations, constructible capital assets, and evolving institutions, without having to become (pardon us the irresistible irreverence!) Leibnizian monads of radical subjectivism.²

In sum, effectuation is based on a Davidsonian view of knowledge, a Penrosian view of resources and a Lachmannian view of institutions. Davidson (2001) argued for an inseparable tripod of subjective, intersubjective, and objective knowledge, Penrose (1959) urged us to focus on how people use resources rather than on what counts as a resource, and Lachmann showed that institutions are artifacts resulting from human action. Effectuation seeks to put the ‘human’ back into human action. To be human, here, is to be a product of physical and historical contingency — a product nonetheless that seeks to impose its will on the very contingency that made it. In this sense, to paraphrase Loasby (1998: 29), effectuation is indeed Lachmannian — optimistic without illusions.

Notes

- 1 An allusion to Edgar Allan Poe's famous lines from *The murder in the Rue Morgue*.
- 2 According to Leibniz, monads differ in quality, and no two monads are exactly alike. Each monad has its own individual identity. Each monad has its own internal principle of being. A monad may undergo change, but this change is internally determined. Changes in the properties of any monad are not externally determined by other monads. Each monad has a plurality of properties and relations, which constitutes its perception. Each monad has its own perceptions which differ from the perceptions of other monads. Perceptual changes are constituted by the internal actions of monads.

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