COMPETITION, ECONOMIC PLANNING, AND THE KNOWLEDGE PROBLEM

THE COLLECTED WORKS OF ISRAEL M. KIRZNER

Austrian Subjectivism and the Emergence of Entrepreneurship Theory

Competition, Economic Planning, and the Knowledge Problem

Competition and Entrepreneurship

Discovery, Capitalism, and Distributive Justice

The Economic Point of View

Essays on Capital and Interest

The Essence of Entrepreneurship and the Nature and Significance of Market Process

Ludwig von Mises: The Man and His Economics

Market Theory and the Price System

Reflections on Ethics, Freedom, Welfare Economics, Policy, and the Legacy of Austrian Economics

ISRAEL M. KIRZNER

Competition, Economic Planning, and the Knowledge Problem

Edited and with an Introduction by

PETER J. BOETTKE and FRÉDÉRIC SAUTET

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INTRODUCTION TO THE LIBERTY FUND EDITION

The present volume of Israel Kirzner's Collected Works contains papers exploring the propositions that can be derived from the consistent application of the entrepreneurial process approach to economics. The articles specifically address competition and the related ideas of plan coordination, economic planning, and the knowledge problem.

Economists are often criticized for offering an abstract and overly simplified view of markets. While the notion of markets is central to the field of economics, it has remained a mysterious concept. The traditional view of "perfect" competition emerged in the 1930s. According to this model, markets are composed of a multitude of agents who have no influence on the prices of goods they buy and sell. Competition is a state of affairs whereby prices and quantities of goods and services are set independent of the actors' decisions, because atomistic individuals allegedly have no influence over market outcomes. The development of competition theory, including oligopolistic competition, during the years preceding World War II, reflected the growing tendency among economists to rely on blackboard theorizing instead of looking to the real world to direct their scholarship. The mathematical properties of economic systems rather than their explanatory potential drove economists' theoretical research.[1] This trend in research shifted the economic paradigm from one of markets as a space for exchange, as developed in the nineteenth century, to one of markets as a metaphor, or a tool to indict reality. In this "modern" approach, markets are disincarnated, and man has become a machine.[2]

The Keynesian transformation finished off whatever was left of the classical idea of the market.[3] John M. Keynes and, later, Paul Samuelson saw the well functioning of markets as an exception rather than the rule. In order for the microeconomy to function, one first had to have the macro balance right. Economists became the new high priests and

1. On this subject, see, for instance, Machovec (1995).

2. See Boettke (1997), Boettke, Coyne, and Leeson (2003), and Sautet (2015).

3. For more on this subject and papers that influenced Kirzner's view, see Friedrich Hayek (1948b), Paul McNulty (1968), and Shorey Peterson (1957).

counselors of the political princes and were called to design institutions and policies aimed at keeping the economy in working order. Both the content and use of economic science changed. The classical era during which economists were humble observers of social realities had come to an end.[4]

It was in this academic and political environment that market process theory developed. Ludwig von Mises's work in the 1920s on economic calculation can be considered as one of the first important landmarks in the field. Subsequently Mises developed an entrepreneurial theory of the market in *Human Action*.[5] He insisted that the market is a process resulting from the interactions of individuals cooperating under the division of labor. Mises's theory was centered on a change agent, the entrepreneur, which explained the true dynamic properties of the market through the continuous adjustments of individual actions. Another important landmark lies in the work of Friedrich Hayek, who offered an epistemic critique of market socialism, equilibrium analysis, and perfect competition. Hayek articulated the central role of dispersed knowledge in markets and its place in economics. He studied the social institutions that help solve markets' epistemic problem.

In the late 1960s, Kirzner started bringing the Misesian and Hayekian analyses together to flesh out an entrepreneurial theory of the market process based on what he later called the Hayekian knowledge problem. That approach became the core of market theory for the new generation of Austrian economists. Market process theory provides an understanding of competition different from that of equilibrium analysis. In fact, seeing the market as a process brings economics back to its nineteenth-century roots, in which competition is about real flesh and blood individuals striving to do better than other market participants by seizing opportunities for profit. In the Kirznerian view, competition is not a state of affairs; it is the process generated through the rivalrous actions of entrepreneurs. This view builds on the work of Mises and Hayek, for whom the important issue was to understand the process that leads to equilibrium, not to assume equilibrium as a starting hypothesis. The way individuals learn is a key element in understanding the market process.

4. See Boettke, Coyne, and Leeson (2006).

5. See especially chapter 15.

As Hayek explained: "if we want to make the assertion that under certain conditions people will approach [equilibrium], we must explain by what process they will acquire the necessary knowledge." (Hayek 1948a, 46) In Hayek's view, studying the properties of equilibrium is a mathematical exercise rather than an economic problem. Instead, the economic problem starts with the assumption that knowledge is dispersed and not available to anyone in its entirety. Perfect knowledge cannot be an assumption within the process of equilibration. Acknowledging the true dispersion of knowledge forces economists to theorize about individuals' decision mechanisms within the limits of the knowledge they possess. In this process, the entrepreneurial function plays the main role.

Through his emphasis on the entrepreneurial dimension of the market process, Kirzner revisited the debates on the meaning of competition and economic planning. At its core, explains Kirzner, competition must be understood as an entrepreneurially driven discovery process. This returns the human element to economic analysis. It sheds a new light on the socialist calculation debate and the limits of government planning, and it opens another window on age-old debates such as the nature of monopoly.[6] One of Kirzner's most important lessons is his emphasis on the discovery process as opposed to the focus of equilibrium analysis on allocative efficiency. As he explains: "The pattern of resource allocation during a given period may, for certain purposes, be considered profoundly unimportant as compared with the speed and smoothness with which misallocations can be discovered and corrected."[7]

In the eyes of famed historian of economic thought Mark Blaug, Austrian economists, and particularly Kirzner, have put forward an analysis that should purely and simply stand at the center of market theory. As Blaug writes in *Economic Theory in Retrospect:*

> I contend that perfect competition is a grossly misleading concept whose only value is to generate an endless series of examination questions. Economics would be a better subject if we discarded it once and for all. Having expunged perfect competition, we ought to follow it

6. While this topic may have brought some disagreements among economists of the Austrian school, it is to Kirzner's credit that he remained open to the idea that monopoly pricing could emerge within the unhampered market. See Kirzner (2013).

7. See Kirzner (2013, 112).

> by also discarding Walrasian existence proofs and the Invisible Hand Theorem of welfare economics. First of all, everyone admits that these beautiful theorems are mental exercises without the slightest possibility of ever being practically relevant: first-best optima are never actually observed and in a second-best world, it is not in general desirable to fulfill any of the first-best optimum conditions; in other words, piecemeal welfare policies may be based on good or bad qualitative judgments but they are not based on rigorous analytical theorems. But once first-best, end-state competition is discarded as irrelevant, as precisely and rigorously wrong, and replaced by process-competition as imprecisely and loosely right, what are we left with? We are left with the content of every chapter in every textbook on imperfect or monopolistic competition, on oligopoly, duopoly and monopoly, in short, on industrial organisation as a sub-discipline in economics. In those chapters, firms jostle for advantage by price and non-price competition, undercutting and out-bidding rivals in the market place by advertising outlays and promotional expenses, launching new differentiated products, new technical processes, new methods of marketing and new organisational forms, and even new reward structures for their employees, all for the sake of head-start profits that they know will soon be eroded. In these chapters, there is never any doubt that competition is an active process, of discovery, of knowledge formation, of "creative destruction." I call this "the Austrian view of competition" because it is most firmly enshrined in the writings of such Austrian economists as Hayek, Schumpeter and, more recently, Kirzner. (Blaug 1996, 594–5)

This volume consists of four sections. The first section contains papers in which Kirzner explores the nature of competition and the role of prices. In the second section the reader will find papers on coordination, the knowledge problem, government planning, and the socialist calculation debate. Note that the section also includes a paper on Hayek's theory of coordination of markets that was originally published in German.[8] This paper is important on two counts. First it partially deals

8. The title is "Hayek's Theory of the Coordination of Markets: A Commentary to Accompany the Facsimile Edition of Hayek's *Preise und Produktion*."

with Austrian business cycle theory, a subject Kirzner has almost never explored in writing; and second, it is published in its original English version for the first time. The section that follows comprises articles on the role of information, knowledge, and advertising. The volume concludes with a section presenting two long articles about market process theory.

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We would first like to thank wholeheartedly Israel Kirzner for his unparalleled contribution to economic science. Kirzner's research program has deeply enriched the discipline and has shed light on some of economics' most difficult puzzles. Economists owe him an immense intellectual debt.

The publication of the Collected Works of Israel M. Kirzner would not be a reality without the participation of Liberty Fund, Inc. We are extremely grateful to Liberty Fund, and especially Emilio Pacheco, for making this project possible. To republish Kirzner's unique oeuvre has been on our minds since our time spent at New York University in the 1990s—where one of us was a professor (Peter) and the other a postdoc student (Frédéric). We are thrilled at the idea that current and future generations of economists and other scholars will have easy access to Kirzner's works.

Finally, we wish to thank Emily Washington for her invaluable help in the publication of this volume, as well as Dr. Stefan Kolev and Dr. Diana Thomas for providing their expertise with German quotations.

Peter J. Boettke and Frédéric Sautet

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THE NATURE OF COMPETITION

CAPITAL, COMPETITION, AND CAPITALISM

Nothing is more fundamental to capitalism than competition, its very lifeblood. It is the interaction of consumers, resource owners, and entrepreneur-producers in free competitive markets which achieves the allocative efficiency and the affluence we take for granted in capitalist societies. At the same time, nothing can be more integral to the definition of capitalism than private ownership of the tools of production. It is, therefore, with puzzled surprise that one finds that private ownership of capital resources has been judged either unnecessary to, or incompatible with, the competitive market's operation.

On one hand, Professor K. Lancaster has recently asserted that a competitive market system does not require private ownership of capital. All the virtues of the system, he claims, could be achieved equally well in a system in which the state was the sole source of capital, providing it at a market-clearing price to all comers.[1] On the other hand, it is more often asserted that private ownership of capital, especially capital necessary to modern industry, operates as a barrier against the entry of new competition. The result is incompatible with the allocative efficiency usually found in the competitive market economy. I shall critically examine the second assertion, but our discussion will reveal certain weaknesses in the first assertion as well. The analysis will reaffirm the vital role private ownership of capital plays in the competitive market process by elucidating the way it supports the efficiency, flexibility, and resourcefulness of the capitalist system.

COMPETITION AND EFFICIENCY

The theory of the competitive market process teaches that where resources within a society leave opportunities for improvement via exchange, production, or some combination of both, they will appear as opportunities

Presented as a lecture at Hillsdale College, Hillsdale, Michigan, February 1974. From *Perception, Opportunity, and Profit: Studies in the Theory of Entrepreneurship* (Chicago and London: University of Chicago Press, 1979), 91–106. Reprinted by permission of Hillsdale College Press; the original source is *Champions of Freedom,* Ludwig von Mises Lecture Series, with presentations by Henry Hazlitt and others (Hillsdale, Mich.: Hillsdale College Press, 1974), 69–91.

for entrepreneurial profit. The lure of profit will lead entrepreneurs to discover these opportunities and pursue them until, through the competitive entrepreneurial process, resources have been reallocated in an equilibrium that eliminates both the profit opportunities and the misallocation. Freedom of entry is crucial to this process. The process depends heavily on the likelihood that, whenever anyone perceives an opportunity for improvement, he will be motivated by the lure of profit to exploit that opportunity. For this actually to occur it is necessary that no one who has perceived such an opportunity be barred from exploiting it. Efficiency in resource allocation might fail to be achieved if the resource is monopolized. Where access to a resource is blocked by its monopolized ownership, the monopolist-owner may find it to be in his own interest to limit production, even where the opportunities for utilization of the resource are fully perceived by other would-be producers. Critics claim that the institution of private ownership of capital serves as an obstacle to competitive market entry, arguing that capitalism is incompatible with competition. Let us state these criticisms more fully.

CAPITALISM AND COMPETITION: THE CRITICISMS

Critics argue that lack of capital may prevent the entrepreneur who has the better idea from following it through. Resources will continue to be used for producing less urgently needed products; resources will continue to be combined less efficiently in production, not because superior modes of utilization cannot be perceived (at least by some potential entrepreneurs), but because these visionary pioneers lack the capital resources needed to implement their projects.[2] As a special example, when a poor youth shows unmistakable signs of exceptional native ability, if he cannot afford an education, he may never take advantage of his talents, and thus society may never enjoy the fruits of his ability. Absence of access to capital has left a valuable resource unexploited.[3] If entrepreneurs who lack capital are unable to compete, then the ideas that do become implemented in production are not necessarily those whose superiority in serving consumers has been proved in the crucible of competition.

It is argued that incumbent firms, by virtue of their ownership of capital—a resource not accessible to many potential competitors—are able to enjoy a monopolistic or oligopolistic position. Capital requirements, serving as a barrier to entry, operate to confer imperfectly competitive market structures upon industries. Inefficiency in resource allocation is seen as inevitable because, given the imperfectly competitive structure of an industry, firms will find it in their self-interest to produce less than the competitive ideal. As E. S. Mason objects, "The capital resources necessary to establish a new firm in an effective competitive position may be so large as to eliminate potential competition as a practical consideration."[4]

This line of criticism, especially when advanced by laymen, is often unhelpfully jumbled with other arguments based on the size of incumbent firms. Many argue that monopoly power is granted by the necessity for a firm to be large in order to take advantage of the economies of scale. With a market limited in total size by demand conditions, economies of scale tend to keep down the number of firms in the market, a circumstance which, in the common view, defines the industry as imperfectly competitive. But this version of the criticism is based on confusion. While the argument that capital requirements constitute a barrier to entry is strengthened by the existence of scale economies,[5] since these will increase the amount of capital needed to compete effectively, the argument does not depend on the superficial identification of large size with monopoly power (an identification derived from considerations of limited size of markets). It depends, in its clearest form, strictly on the contention that capital requirements serve to bar entry into industries. We shall appraise capital requirements in this form.

OWNERSHIP, ENTREPRENEURSHIP, AND PROFITS

Critical discussion of the thesis of capital as barrier against entry requires that we first clarify several widely misunderstood aspects of entrepreneurial profits. The common view sees profits as ordinarily accruing to the owner of an enterprise.[6] The entrepreneur is seen as capturing profits through his successful deployment of the resources of his firm. This identification of the owner as the recipient of entrepreneurial profit has been responsible for difficulties economists purport to have discovered in the modern corporation. The modern large corporation is owned by stockholders who exercise virtually no day-to-day control over the use of the corporate resources. Ownership apparently has come to be divorced from control over firm assets. In the Berle-Galbraith view of things, this circumstance shatters the traditional view of profit's role in shaping the pattern of production. In the traditional view, the lure of profits spurs producers to serve consumers; in the corporation the production decisions are not made by owners, to whom profits accrue, but by a new class of corporate managers who find little personal incentive in providing corporate profits for stockholders. It is not our purpose to expose the fallacies in this Berle-Galbraith doctrine on the corporation at this point. We merely note that it rests on an uncritical acceptance of the view that entrepreneurial profits go to the owners of business firms. It is only because profits are believed to accrue only to owners that the stockholders' lack of power appears to contradict the assumption that corporate production decisions are actuated by the profit motive. Later on, we will revert critically to this aspect of the Berle-Galbraith view of the modern corporation.

In contrast to this widespread position linking profit with the ownership of assets, there flows from the Misesian analysis of the market process an entirely different view of entrepreneurial profits. Entrepreneurial profits, in this view, are not captured by owners, in their capacity of owners, at all. They are captured, instead, by men who exercise pure entrepreneurship, for which ownership is *never* a condition.

The Misesian theory of entrepreneurial profit can be described as an "arbitrage" theory of profit.[7] "What makes profit emerge is the fact that the entrepreneur who judges the future prices of the products more correctly than other people do buys some or all of the factors of production at prices which, seen from the point of view of the future state of the market, are too low."[8] Profits arise, then, from the absence of adjustment between the prices on different markets. Entrepreneurship does not consist in exchanging (or physically converting) owned assets of low value into assets of higher value. It consists in exploiting the difference between two sets of prices for the same goods. It consists in buying at the low price and selling at the higher price. Where the opportunities to buy and to sell are, as in pure arbitrage, truly simultaneous, in principle no initial resources are needed at all. The higher price obtained from the sale is more than sufficient to pay the low price that must be paid simultaneously for the purchase. In the more general case of entrepreneurship exercised across time, purchase must precede sale; the capture of profit requires the investment of capital.

> But it is still correct to insist that the entrepreneur qua entrepreneur requires no investment of any kind. If the surplus (representing the difference between selling price and buying price) is sufficient to

enable the entrepreneur to offer an interest payment attractive enough to persuade someone to advance the necessary funds, it is still true that the entrepreneur has discovered a way of obtaining pure profit, without the need to invest anything at all.[9]

Recognition that entrepreneurship, in the pure sense, does not require any prior ownership should not prevent us from seeing how an entrepreneur *may,* at the same time, be an owner. Instead of employing a resource in a standard, routine use for which its productivity at the margin is widely known and is already precisely reflected in its own market price, an owner of a resource may deploy it in a new, imaginative fashion yielding a sales revenue far in excess of its own current market price. But clearly the same entrepreneurial success might have been obtained by a nonowner purchasing the same resource in the market at its low price and deploying it in the novel way. Where the resource owner himself acted entrepreneurially in production, we should see him as having "purchased" the resource from himself at the current market price. When an entrepreneur has purchased a good for subsequent resale, he has become the owner of the good. When he does subsequently sell the good at a profit-yielding price, it might appear that it is as an owner that he has captured that profit. But reflection will confirm that the successful decision to which the entrepreneur must attribute his profit was made at a time when he was not yet the owner of the good he has now sold. The entrepreneurial decision is that which inspired him to buy the good in the first place for the sake of its expected sale at a later date. Clearly, then, while we see profits captured by owners, we must perceive that ownership has nothing to do with these profits, and by the same token, essentially nothing to do with the exercise of entrepreneurship.

CAPITALISTS AND ENTREPRENEURS

From the foregoing discussion there emerges with clarity the very important distinction that separates the role of the entrepreneur from that of the capitalist. The capitalist's role in the production process derives wholly from his ownership of resources. The capitalist is the resource owner who, in return for the promise of interest payments, is willing to permit his resources to be used in economic processes extending over time. The entrepreneur is one who perceives in a way the capitalist himself does not how these resources can be deployed in a way that can justify contractual interest payments to prospective investors. It is the entrepreneur who acquires these resources from the capitalist at the "low" price including interest in order to yield an even higher sales revenue at a later date.

To fulfill the capitalist role in production, it is necessary to own resources that can be offered in the market to producers, and to be prepared to wait for payment until these resources generate revenue in relatively time-consuming processes of production. Without prior ownership of productive resources, or funds able to command resources, it is as impossible to be a capitalist as to be a laborer without possessing the capacity to work. But to fulfill the entrepreneurial role, as we have seen, no prior ownership of any resources is needed. It is necessary for the prospective entrepreneur merely to be alert to the possibility of securing the means of production from capitalists and other resource owners to produce a final sales revenue greater than the sum of the amounts he must offer them in return.

It is true that, in the complexity of the real world, we must not expect to discover pure analytical categories. Those exercising entrepreneurship in the real world are likely to be resource owners at the same time. A laborer may borrow capital and produce a product which, after full payment of the costs of capital, leaves a surplus higher than the market value of his labor. And we have already noticed that the exercise of entrepreneurship will render the entrepreneur an owner of that which he has purchased, for the period between its purchase and its later sale. So those who have exercised entrepreneurship appear as current owners of assets. But this does not in any way diminish the power of our conclusion that entrepreneurship as an analytical category does *not* call for the prior ownership of anything as a prerequisite.

Acceptance of this important conclusion may be hampered by the circumstance that we may be unlikely to discover a pure entrepreneur or a pure capitalist. As Mises has pointed out, "every action is embedded in the flux of time and therefore involves a speculation";[10] the decision to lend capital is itself partly an entrepreneurial one, because it involves the possibility that the borrower may be unable to carry out his side of the contract. "A capitalist is always also virtually an entrepreneur and speculator."[11]

But the fact that every capitalist must be an entrepreneur does not in any way logically entail that to become an entrepreneur one must