COMPETITION AND ENTREPRENEURSHIP

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 and Entrepreneurship

Edited and with an Introduction by

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INTRODUCTION TO THE LIBERTY FUND EDITION

By the 1960s, macroeconomics had become dominant in economic science. Not only did the Keynesian revolution silence those who favored market mechanisms over government intervention, but it also promoted the view that the meaningful and relevant economic variables must be examined in terms of aggregates. In the midst of all this, a few economists such as James Buchanan, Ronald Coase, Harold Demsetz, Milton Friedman, and Gordon Tullock continued to think in the tradition of rational choice theory and methodological individualism. The minority that wasn't swept away by the macroeconomics wave started to rebuild the discipline of economics on better foundations, which led to the revival of price theory at the University of Chicago.

It was in this climate that Israel Kirzner worked on some microeconomic aspects of economic systems such as capital theory and market process. Kirzner's search for the meaning of market process had started during his student years under Ludwig von Mises. However, the turning point came a decade later, in 1967, with the preparation of a lecture for the Mont Pelerin Society meeting in Vichy, France. In his lecture, Kirzner defined for the first time in his career the role of the entrepreneurial function in the market system. He started to see the contour of a theory that would spell out the view of the market as an entrepreneurial process.[1] In the years following that presentation, Kirzner spent time reflecting, developing, and writing a theory of the market process centered on the primacy of entrepreneurship.

Competition and Entrepreneurship was published in 1973 by the University of Chicago Press and has been in print without interruption since the date of its first publication. Unlike other books Kirzner wrote later in his career, *Competition and Entrepreneurship* is a monograph instead of a collection of previously published articles.

One cannot underestimate the importance of *Competition and Entrepreneurship* in Kirzner's career, since it defined his unique contribution

1. Kirzner's 1967 presentation at the Mont Pelerin meeting in Vichy was published in *Il Politico* and is republished in *Austrian Subjectivism and the Emergence of Entrepreneurship Theory,* in the present collection.

to the economics profession. At the moment of its publication, however, the book did not attract the attention of many economists. It was mostly ignored by the mainstream even though it represented an enlightened critique of price theory. This is the point Benjamin Klein made in a scathing critique of the book. Klein explained: "Because of its peculiar methodology and language, [*Competition and Entrepreneurship*] is unlikely to have a large impact on the profession."[2] While Klein agreed, on some level at least, with Kirzner's research agenda,[3] he clearly stated that Kirzner fell short of providing an alternative model to microeconomic theory as it stood then. The lack of formalization and the focus on the elusive idea of entrepreneurship made it difficult for economists trained in traditional industrial organization and market theory to understand Kirzner's new approach.[4]

Competition and Entrepreneurship was acclaimed by many Austrian economists, although it fueled a series of endless debates among them about the nature of entrepreneurship and market process. Even though Murray Rothbard criticized Kirzner for holding the view that entrepreneurship should be regarded as separate from asset ownership, he said of the book that it was "the fullest elaboration to date of the Mises–Hayek view of entrepreneurship and competition, as well as a critique of existing orthodox microeconomics."[5] Kirzner himself did not claim to provide anything new, but simply to elaborate on the works of Ludwig von Mises and Friedrich Hayek.

The book, however, is more than a simple elaboration on pre-existing theories. It is true that, on the one hand, Kirzner's work is one of synthesis.

2. See Benjamin Klein's review of the book in *The Journal of Political Economy,* vol. 83, no. 6 (December 1975): 1308.

3. As Klein put it: "Kirzner's message regarding the direction in which price theory should develop is important and would certainly be welcomed by the profession at this point in time." Ibid.

4. Robert Ekelund's review of *Competition and Entrepreneurship,* although much more positive than that of Klein, makes a similar point at the end: Kirzner "denotes far too much space to the errors of the `misguided orthodoxy' and too little to the development and elaboration of his alternative interpretation." *Southern Economic Journal,* vol. 41, no. 1 (July 1974): 156.

5. See Murray Rothbard's review of the book in the *Journal of Economic Literature,* vol. 12, no. 3 (September 1974): 903.

He built upon the Misesian notion of *homo agens* and Mises's view of the entrepreneurial role. He also used Hayek's analysis of the dispersion of knowledge in society and reframed the economic problem as one of coordination of individual plans.

On the other hand, Kirzner opened the door of the modern theory of market process by going beyond Mises's and Hayek's respective views. Kirzner's goal was to reconstruct market theory.[6] Indeed, while Mises offered a theory of the entrepreneur in his work, it lacked an integration of the entrepreneurial role in the market and thus remained somewhat obscure regarding the nature of market process. As for Hayek, he built a theory of knowledge dispersion both in response to the development of neoclassical competition theory in the 1930s and as part of the socialist calculation debate, but he never fully explained how the knowledge problem came to be solved. It was Kirzner's achievement to build upon the works of these two economists; as a result, he anchored market process theory as a discipline. Kirzner's research program demonstrated how entrepreneurship marshals and generates the knowledge needed for the coordination of individuals' plans and the emergence of the social order.

Competition and Entrepreneurship laid a solid foundation upon which Kirzner and others would build. In spite of its limitations, the book is a major contribution to one of the most difficult problems of economics: how to account for change and novelty in an economic system. In order to address this fundamental problem, Kirzner offers a theory of entrepreneurship and market process, two issues that had been largely avoided in the literature. Indeed, following Frank Knight's assessment that no science of economics was possible in a world of radical uncertainty,[7] the profession, with a few exceptions, had focused its attention on closed models in which no new information and knowledge ever arises. For instance, this was the view Harold Demsetz adopted when he explained that the

6. As Kirzner put it: "Our position will call for reconsidering very substantial portions of the theory of price" so that "a reconstructed theory of the market may be built." (*Competition and Entrepreneurship,* p. 2). He also says further: "the purpose of this book [is] to liberate the theory of price from the unrealistic confines of . . . an artificially restricted world" (p. 174).

7. See Frank Knight, *Risk, Uncertainty and Profit* (Boston: Houghton Mifflin Company, 1921).

neglect of the entrepreneur in the literature was to be expected and was analytically unavoidable.[8]

As Kirzner saw it, the problem of entrepreneurship as an analytical category stems from the insight that we cannot explain the existence of sheer novelty (and pure profit) by referring to productive factors already in use. Kirzner presented the profession with a most daring solution, confronting head-on the problem of change and novelty by devising a theory that could account for the presence of pure profit in the market by focusing on the *pure* entrepreneurial element in human action. To that end, he distinguished optimizing behavior from entrepreneurial alertness. Isolating the two functions led him to posit the distinction between entrepreneurship and asset ownership.[9] Kirzner also used the equilibrium construct as a foil against which he could study the role of the entrepreneurial function. For it is only against a background of optimizing agents (i.e., Robbinsian maximizers, to use Kirzner's terminology) that one can illumine the role of the entrepreneur.

In addition to offering solutions to important problems of economic theory, *Competition and Entrepreneurship* opened the door to further debates that Kirzner and his critics engaged in during the years that followed the book's publication. The book has provided the foundation against which most of the work on entrepreneurship in Austrian theory has been judged. For instance, the importance of equilibration in market process and the role of uncertainty in entrepreneurship became hotly debated topics thanks, at least in part, to the publication of Kirzner's book.

While the wider impact of the book in the years directly following its publication was disappointing, its influence has grown and continues to grow. For instance, Kirzner introduced the concept of "alertness" as the main defining characteristic of entrepreneurship. Alertness was virtually unused in entrepreneurship studies in the decade that followed the publication of the book.[10] In contrast, from 2004 to 2008 the notion of

8. See Harold Demsetz's "The Neglect of the Entrepreneur" in Joshua Ronen (ed.), *Entrepreneurship* (Lexington, Mass.: D. C. Heath and Company, 1982).

9. This distinction started a controversy among Austrian economists. This controversy is explored, along with others, in subsequent volumes.

10. We only found three references to alertness during that period in the scientific reviews on entrepreneurship available at the time.

alertness appeared in fifty-seven articles in top academic journals on entrepreneurship, most of them in direct relation to Kirzner's work.[11]

Kirzner understood well the implications of the idea that optimizing behavior cannot explain the market as a process. Without the introduction of ad hoc exogenous elements, economics is limited in its capacity to explain social change and novelty. This is not to say that the equilibrium construct is to be jettisoned; it occupies an important place in the toolbox of the economist, because it is only by reference to equilibrium that one can understand change. Economics, however, focused so much on the absence of change that it became detrimental to what economists were trying to explain. In this sense, Kirzner's research is fundamental, as it puts the notion of change (and its study) back at the center of economic theory.

ACKNOWLEDGMENTS

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 especally 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 post-doc 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 Rosemarie Fike for her invaluable help in the publication of this volume.

Peter Boettke and Frédéric Sautet

11. The journals we examined were *Journal of Business Venturing, Small Business Economics, Entrepreneurship: Theory & Practice, Journal of Small Business Management, International Journal of Entrepreneurship, Journal of Developmental Entrepreneurship, Journal of Enterprising Culture,* and *New England Journal of Entrepreneurship.*

PREFACE

Recent years have witnessed a revival of interest in microeconomic aspects of economic systems. The theory of price has once again become the core of economic analysis. For the most part, however, contemporary price theory has continued to be presented within an equilibrium framework. This not only has diverted attention away from the market process and toward equilibrium, but has led to virtual exclusion of the entrepreneurial role from economic theory.

Thoughtful critics of contemporary price theory have very recently begun to draw attention to these shortcomings. Some of the writings of Abbott, Baumol, Brozen, Dewey, Leibenstein, McNulty, and D. McCord Wright, despite the wide differences among them, reflect a common concern with the failure of contemporary microeconomics to grapple with the market process. What has been generally overlooked, however, is the existence throughout this century of at least one tradition of economic thought in which these shortcomings have never been permitted to appear. While the Anglo-American tradition deriving from neoclassical price theory has remained frozen within the equilibrium framework, the writers who took their origin from the Austrians have consistently worked along lines in which entrepreneurship and market processes received their proper due. This book can be viewed as a critique of contemporary price theory from an "Austrian" perspective; or it may be viewed as an essay on the theory of entrepreneurship, or on the theory of competition. Its purpose is in fact to show that these views coincide. Besides its emphasis on entrepreneurship, the book offers a new perspective on quality competition, on selling effort, and on the fundamental weakness of contemporary welfare economics.

Among those with whom conversation or correspondence has proved helpful I gratefully recall J. Buchanan, R. Coase, D. Dewey, L. Lachmann, H. Demsetz, G. Tullock, and A. Zabarkes. Above all I owe whatever understanding I have of the market process to almost two decades of study under L. Mises, whose ideas as expounded in a lifetime's work are only now beginning to be properly appreciated. I acknowledge with gratitude the generous research support I received from the New York University Schools of Business Research Office and from the Relm Foundation. Of course responsibility for any inadequacies in this book rests with me alone.

COMPETITION AND ENTREPRENEURSHIP

1 MARKET PROCESS VERSUS MARKET EQUILIBRIUM

This book is an attempt toward a theory of the market and of the price system that differs in significant respects from the orthodox theory of price. In this introductory chapter I will briefly survey the range of problems we will be dealing with and outline the salient points of difference that will set my own approach apart from the standard approach to microeconomic theory. As we will discover, the most important of these differences finds expression as dissatisfaction with the usual emphasis on *equilibrium analysis,* and in an attempt to replace this emphasis by a fuller understanding of the operation of the market as a *process*. Much of this chapter will therefore be devoted to this issue.

THE MARKET SYSTEM AND THE THEORY OF THE MARKET

The theory of the market—more usually but less felicitously known as the theory of price or as microeconomic theory—is founded on the basic insight that market phenomena can be "understood" as the manifestations of systematic relationships. The observable phenomena of the market—the prices at which commodities are exchanged, the kinds and qualities of commodities produced, the quantities exchanged, the methods of production employed, the prices of the factors of production used, the structure of the various markets, and the like—are seen not as masses of isolated, irreducible data but as the outcomes of determinate processes that can, in principle, be grasped and understood.

This fundamental insight has been explored and exploited by the many theorists who have contributed over many decades to the edifice of price theory. They have studied ways in which market phenomena depend on one another, developing theories of consumer demands, of production, and of market prices for commodities and factors that indicate the chains of causation that link together the basic data of the market—the arrays of tastes, technological possibilities, and resource availabilities—with the observable phenomena of the market system.

From this intensive intellectual activity over the years there has emerged an imposing structure that constitutes a well-recognized body of theoretical knowledge, the theory of price. The theory as it is presented in the textbooks and taught in the classroom is rather well established. There were many lively—sometimes furious—controversies during the history of price theory; and there were on occasion complete "revolutions" involving drastic reworking of the entire corpus of theory. There is still much activity, and original work is still being done on particular pieces of the structure; there have been repeated strong expressions of dissatisfaction with particular parts of the theory; and there is, has always been, and probably always will be sharp criticism, of the entire approach taken by price theory, of its assumptions, its method, and the relevance and validity of its conclusions. But, granting all this, it yet remains true that "orthodox" price theory as standardly presented is less controversial and in less of a ferment than other parts of economics.

The dominant "orthodoxy" in Anglo-American price theory has clearly visible roots in the earliest divergent schools of economic thought. The major element is clearly Marshallian in origin, modified by the Robinson-Chamberlin innovations of the thirties, perhaps enriched here by the infusion of Walrasian general-equilibrium insights and there by the absorption of Austrian ideas on cost, and rendered more sophisticated throughout by more refined geometrical techniques and more rigorous by increased dependence on mathematics as a language. Contemporary price theorists will generally argue, with some justification, that little that was valuable in any of the opposing views aired in past controversies is absent from the widely shared corpus of modern price theory.

The position that I will take diverges in several significant respects from this generally approving view of the contemporary theory of price. I will argue that the direction in which the dominant stream of microeconomic thought has flowed must be judged, on several counts, to be an unfortunate one; that some of the less sophisticated views of participants in earlier controversies, views which have *not* found their way into the modern theory, reflected more penetrating and useful insights into the operation of the market than the modern theory possesses. I will argue that the dominant theory not only suffers from serious weaknesses as a vehicle for economic understanding, but has also, as a result, led to grievously faulty conclusions for economic policy. Our position will call for reconsidering very substantial portions of the theory of price, and I will attempt to point to the lines along which a reconstructed theory of the market may be built.

As the reader will discover, there is little I will say that has not been said somewhere by someone. The position taken up in this essay does