

**THE ESSENCE OF
ENTREPRENEURSHIP
AND THE NATURE
AND SIGNIFICANCE
OF MARKET PROCESS**

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

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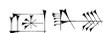
Edited and with an Introduction by

PETER J. BOETTKE AND FRÉDÉRIC SAUTET



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by Peter J. Boettke and Frédéric Sautet

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INTRODUCTION TO THE LIBERTY FUND EDITION

This volume goes to the heart of Israel Kirzner's most important work, presenting his fundamental papers on entrepreneurial alertness and market process. Kirzner's work has been recognized not only in the world of Austrian economics but also in the field of entrepreneurship studies. Indeed, the last two decades have seen his oeuvre become a cornerstone of that discipline.¹ Many scholars now refer to Kirznerian alertness as one of the important theoretical insights to understanding the entrepreneurial function. This is reflected in the works of Sankaran Venkataraman and Scott Shane who are two significant witnesses to the growing importance of Kirzner's research in entrepreneurship studies. One can credit Kirzner's influence for helping these scholars shift the focus of their discipline away from a strict behavioral approach—which is mostly concerned with defining and understanding the entrepreneurial profile—toward a more cognitive one. Venkataraman's *The Distinctive Domain of Entrepreneurship Research* (1997) and Shane's *Prior Knowledge and the Discovery of Entrepreneurial Opportunities* (2000) are instances of works that have pushed the cognitive approach to entrepreneurship into the foreground. While studying the profiles of entrepreneurs has generated important results, the profession has now realized that it is also crucial to understand how entrepreneurs come to recognize the existence of opportunities. In other words, the fundamental question has become “why do people discover some entrepreneurial opportunities and not others?” (Shane, 2000, 451)

As a result, more and more research is directed toward understanding both the origins of entrepreneurial opportunities and the discovery process. Venkataraman's and Shane's emphasis on entrepreneurial discovery and the role of prior knowledge has become a theme of numerous studies that have sought to shed light on these questions.² Some of

1. Kirzner received the Global Award for Entrepreneurship Research in 2006. The prize committee stated: “Kirzner's theory building has had great impact on the development of the entire field of entrepreneurship research, not to mention it has been applied empirically in several adjacent fields.”

2. See for instance the papers of Gaglio and Katz (2001) and Shepherd and DeTienne (2005). See also Sarasvathy (2008).

the core views that have emerged in the last two decades in entrepreneurship research are direct applications of the work of Friedrich Hayek on knowledge dispersion and of Israel Kirzner on the entrepreneurial function. In many ways, the Austrian approach has now become part of the foundational landscape of entrepreneurship research. To a large extent, this new direction can be attributed to Kirzner's work and its influence.

The essence of entrepreneurship in Kirzner's work revolves around the fundamental idea that the discovery and exploitation of gains from trade does not take place automatically, but rather stems from purposeful human action. This departs from traditional microeconomics in which existing gains from trade are always known. Instead, Kirzner emphasizes that in order for these gains to be exploited, they first have to be noticed. The essence of the entrepreneurial function rests on this fundamental insight. For decades, this view escaped the mind of economists who did not notice its importance. But researchers in the field of entrepreneurship studies eventually did. In defining the distinctive domain of entrepreneurship research, Shane and Venkataraman (2000) put forward the importance of knowledge dispersion and opportunity recognition as a cornerstone of the new research framework, thereby recognizing the essence of Kirzner's work.

Unlike entrepreneurship research, the mainstream of economic science continued to adhere to deterministic mechanisms and a purposeless view of human action, which led to a rigid framework to explain individual choice. Once individual preferences are assumed and the constraints are known, microeconomics tells us what the individual will do. There is not much "choice" left in this framework, if one understands by choice an element of human action that is not directly under the sway of deterministic forces. Some economists, such as George Shackle (1972), sharply criticized this approach purporting that nothing can ever rigidly determine human decisions. In Kirzner's view, however, Shackle went too far in denying the relevance of the framework that shapes human choices, but he was right in emphasizing the presence of an indeterminate element in human action: the entrepreneurial function. Kirzner built his theory of entrepreneurship by opening up the framework of choice that defines human action, while keeping the system within the boundaries of rational choice theory. In this gap between the straitjacket

of deterministic microeconomics and Shackle's kaleidic world lies the essence of entrepreneurship.³

Kirzner has been criticized for defining the entrepreneurial function within the context of traditional microeconomics and insisting on the individual's ability to notice what was previously unknown. Can homo agents fit in a framework for homo economicus? Kirzner meets the challenge by relaxing the strict behavioral and cognitive assumptions of traditional theory, while not abandoning the logical structure of market theory and relative price adjustments.

Traditional price theory is caught in a logical conundrum identified by Kenneth Arrow.⁴ If economic actors are price takers as postulated in the theory of general competitive equilibrium, then how do prices ever adjust to clear markets? And, furthermore, if we have no theory of price adjustment, then how will markets converge on an equilibrium path from a situation of disequilibrium? As Joan Robinson pointed out long ago, it appears that the only way an economy can reach equilibrium is to be already in equilibrium.⁵ The implications of this theoretical lacuna are significant, and threaten the intellectual legitimacy of the entire neoclassical theory of the market economy. Franklin Fisher explained succinctly in his *Disequilibrium Foundations of Equilibrium Economics* (1989) that either we have good reasons to believe that an economy in disequilibrium will find an equilibrium path, or we must abandon neoclassical welfare economics and the conclusions derived about the tendencies toward market clearing, efficiency of decentralized markets, and economic coordination.

In contrast with traditional microeconomics, Kirzner's view of the entrepreneurial function in the market process consists primarily in liberating human choice from its deterministic structure by introducing alertness. Alertness to unexploited gains from trade sets the market process in motion. Thus, the notion of alertness is crucial also because of

3. Garrison (1982) contends that Kirzner adopted a middle-of-the-road view of economics.

4. See Arrow's paper, "Toward a Theory of Price Adjustment," in *The Allocation of Economic Resources: Essays in Honor of Bernard Francis Haley*, edited by Moses Abramowitz (1959). See also Arrow (1994).

5. See for instance "History and Equilibrium" and "The Disintegration of Economics" reprinted in volume 5 of her *Collected Works* (1979).

its relationship to market process. Entrepreneurial alertness is critical to Kirzner's development of the theory of the competitive market process, and this theory provides us with the disequilibrium foundations to classical and neoclassical market equilibrium analysis, offering a response to Arrow's challenge.⁶

Starting in 1967 with the publication of "Methodological Individualism, Market Equilibrium, and Market Process," Kirzner's research on the role of the entrepreneurial function led him to reconsider the nature of the market. The logic of market equilibrium implies that participants always act optimally under given circumstances and with perfect knowledge. In this world, prices and quantities reflect a full mutual adjustment of individual plans; there is no ignorance that is not revealed in the current state of the market. Agents are fully aware of the true situation in which they find themselves. Hayek often emphasized that what matters is not so much what happens in equilibrium but what happens on the path to it. If we assume that knowledge is truly dispersed and plans, as a result, are not well coordinated, then the entrepreneurial function becomes a fundamental aspect of the market system. In this approach, the market is a process rather than a state of affairs.

Kirzner's analysis of the market process is in harmony with the general findings of entrepreneurship studies yet distinct from this line of research. Alertness can be observed through personality traits such as self-motivation, self-efficacy, effectuation, and superior risk assessment. Moreover, entrepreneurs (a) constantly make judgments about the future state of the market, (b) are generally creative and innovative, and (c) often invest their own capital in the early exploitation of opportunities.⁷ While all these attributes are important, they are not fundamental to Kirzner's view of entrepreneurship. Indeed, the essential aspect of his market process is the persistent alertness of entrepreneurs to hitherto unknown profit opportunities. Because of this defining characteristic of

6. Given the significance of the problem of open-endedness for the enterprise of economics, and the ingenious way in which Kirzner provides an endogenous solution to it, it is our sincere hope that he will one day be honored by the Nobel Prize committee in Sweden for this technical point in price theory.

7. Some economists have criticized Kirzner's view of the entrepreneurial function as being too abstract and not grounded enough in the daily reality of entrepreneurs and organizations. See, for instance, Klein (2008).

entrepreneurs, Kirzner repeatedly emphasizes the idea of the market as a discovery procedure.

This volume contains three sections. The first section presents some of the papers in which Kirzner has defined the essence of entrepreneurship, while the second and third sections include papers on market process theory. Kirzner explores the implications of allowing the entrepreneurial element to exist in the choice-theoretic framework of microeconomics. It is here that we see the full implication of the idea that the discovery of gains from trade is not an automatic and necessary process. These papers, along with his book *Competition and Entrepreneurship* (1973), present the core of Kirzner's view. They also help us see his evolution since the early 1970s, and how he fleshed out his view of entrepreneurship and market process. Note that section two on market process includes papers on growth, development, and entrepreneurial error. It also contains two debates, on the nature of entrepreneurship with Martin Ricketts and on the market process with Stephen Shmanske. The last section presents articles on the subject of supply and demand, including a critique by James Ahiakpor and Kirzner's reply.

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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 post-doctoral 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.

Peter J. Boettke and Frédéric Sautet

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**THE ESSENCE OF
ENTREPRENEURSHIP**

ENTREPRENEURSHIP

A solid case can be made for the claim that entrepreneurship has, throughout the history of the Austrian school, been among its central theoretical constructs. In their history of the variety of ways of understanding the essence of entrepreneurship, Hébert and Link (1988, p. 64) refer to the three “distinct viewpoints” in early neoclassical economics (the “Austrian, French and British”). They remark that, “of the three, the Austrian approach proved most fertile for advancing the theory of the entrepreneur.” In a paper exploring aspects of the history of entrepreneurial theory, Dolores Tremewan Martin (1979, p. 271) observes that “much of the modern economic analysis . . . is devoid of any serious consideration of the role of the entrepreneur . . .,” but adds in a footnote that “the primary exceptions to this general trend in the literature are found in the writings of the ‘modern Austrian economists.’”

In the following pages we will briefly examine some highlights in the history of Austrian theories of entrepreneurship; canvass some contemporary disagreements among Austrians in regard to entrepreneurship; and seek to explain why it was that the Austrians, rather than other schools of marginalist economics, came to assign such importance to the entrepreneurial role.

THE ENTREPRENEUR IN THE EARLIER AUSTRIAN TRADITION

It is well known that it was only in the course of the marginalist revolution that economists came to recognize an analytically distinct role for the entrepreneur. In classical economics—or at least in its dominant British version—there was simply no distinct entrepreneurial function. It was the capitalist upon whom, it appears, the economists implicitly relied to assure fulfillment of the tasks we generally consider to be entrepreneurial. The profit share of income earned by the capitalist, in classical economics, corresponded mainly in fact to what neoclassical economics was to identify as interest on capital. For the classical economists there was no pure entrepreneurial profit, because for them there

From *The Elgar Companion to Austrian Economics*, ed. Peter J. Boettke (Aldershot, U.K.: Edward Elgar Publishing, 1964), 103–10. Reprinted by permission of the publisher.

was no pure entrepreneurial role. It was in the course of the neoclassical development of the theory of the market that economists came to recognize the importance of the function played by the entrepreneur who acquires all the resource services—including those of capital—in order to produce the product to be sold to consumers. During the 1880s and 1890s there emerged a small flood of articles dealing with this entrepreneurial role. It was at this time that the American theorists, J. B. Clark and Frederick B. Hawley, developed their separate theories of pure profit (upon the elements of which Frank Knight was later to build his own more nuanced theory). It was soon after this period that the Austrian J. A. Schumpeter introduced his own theory of the entrepreneur, laying the foundation for his characteristic way of seeing and understanding the capitalist process.

The Austrians were prominent participants in this discovery of entrepreneurship. Carl Menger had already, in his 1871 *Grundsätze*, paid some significant attention, at least, to the entrepreneurial function. In characteristic subjectivist fashion, indeed, Menger (1950, p. 160) emphasized the element of information and the act of will involved in this entrepreneurial function (although, unlike Schumpeter and later Austrians, he saw the exercise of this function as merely a special kind of labor service). During the 1880s his teaching apparently inspired two of his students, Mataja and Gross, each to write his dissertation on the entrepreneurial role. There has been some disagreement among historians of thought concerning the influence exercised by Menger upon subsequent Austrian developments in the theory of entrepreneurship. Streissler (1972, pp. 432f) has maintained that Schumpeter built his own theory of entrepreneurial innovation largely on Menger's foundations. This seems to contrast sharply with Knight's typically dismissive assessment of the influence of Menger's contribution in this respect. (See also Martin, 1979; Kirzner, 1979, chapter 4, for discussions of Menger's concept of the entrepreneur in the context of the subsequent Schumpeterian and Knightian views.) Be this as it may, there seems little ground to doubt that Schumpeter's own emphasis on the entrepreneur was rooted, not in his well-known admiration for Walrasian general equilibrium theory, but in the subjectivist, Austrian legacy he imbibed from Böhm-Bawerk's seminars.

An assessment by the historian of thought of the state of entrepreneurial theory in the economics of 1914 would recognize the importance

of the Austrian contributions, but would certainly not pronounce entrepreneurial theory to be exclusively or even predominantly the province of the Austrians. The bulk of the prewar literature on entrepreneurship and on entrepreneurial profit was certainly contributed by economists of other schools. Yet general mainstream interest in this branch of economic theory was to decline sharply following the war. Knight's work would of course represent a magisterial contribution to the identification of the entrepreneurial role and to the understanding of pure entrepreneurial profit. It offered a crystal-clear articulation of the distinction between the utterly certain Walrasian world of perfectly competitive equilibrium and the real world of radical, inescapable uncertainty. But the progress of mainstream neoclassical economics in the succeeding half-century was virtually to ignore the implications of this distinction. Even among Knight's own disciples microeconomics came to mean, in the second half of the twentieth century, the theory of markets in complex competitive equilibrium, with no possibility of pure profit, and none of the uncertainty which calls forth the special characteristics of the Knightian entrepreneur. It was during this period that understanding of the entrepreneurial role became, if only by default, more or less an exclusively Austrian concern. It was in the economics of Ludwig von Mises that this was most obvious.

ENTREPRENEURSHIP IN MID-TWENTIETH-CENTURY AUSTRIAN ECONOMICS

What Mises contributed to the theory of entrepreneurship may not be immediately obvious to the superficial reader of his works. Although the index to his *Human Action* (1949) demonstrates the importance of the entrepreneur for Misesian economics, a reader may be excused for concluding that what Mises had to say about the entrepreneur was not exactly pathbreaking. The nuances which separate the Misesian entrepreneur from the Schumpeterian or the Knightian might well appear to be only of marginal significance, but the truth is that it is indeed the role which Mises assigns to the entrepreneur which sets Misesian economics so decisively apart from mainstream mid-twentieth-century economics. And the modest revival of the Austrian approach during the past two decades must be seen as recognition of the valuable character of precisely this aspect of the Misesian system.

What sets the Misesian system apart from mainstream neoclassical economics is the Misesian portrayal of *the market as an entrepreneurially driven process*:

The operation of [the factor] market is actuated and kept in motion by the exertion of the promoting entrepreneurs, eager to profit from the differences in the market prices of the factors of production and the expected prices of the products . . . The activities of the entrepreneurs are the element that would bring about the unrealizable state of the evenly rotating economy if no further changes were to occur . . . The competition between the entrepreneurs . . . reflects in the external world the conflict which the inexorable scarcity of the factors of production brings about in the soul of each consumer. It makes effective the subsumed decisions of the consumers as to what purpose the nonspecific factors should be used for and to what extent the specific factors of production should be used. (1949, pp. 331, 335)

It was in the course of the famed inter-war debate on the possibility of economic calculation under socialism that Mises's entrepreneurial view of the market process came to be crystallized and subsequently clearly articulated. As Lavoie has emphasized, it was appreciation for the entrepreneurial character of the market process which enabled the Austrians to see the fallacy of quasi-market "solutions" (such as those of Lange and Lerner) to the calculation problem. This writer has argued that Hayek's important contributions to the calculation debate, although couched in terms of utilization of knowledge rather than in terms of entrepreneurial discovery, ultimately reflect, at least implicitly, a similar understanding of the market process.

In fact the novelty of the Misesian perception of the market as a continuing process of entrepreneurial competition is mute evidence of the drastic decline, in mid-twentieth-century mainstream economic thought, of awareness of the entrepreneurial role. As Baumol has observed, the entrepreneur had virtually disappeared from the theoretical literature. And it was indeed the Misesian emphasis on the entrepreneurial role which inspired subsequent Austrian interest in the theory of entrepreneurship.

THE MISESIAN ENTREPRENEUR FURTHER EXPLORED

Much of this subsequent Austrian interest has been reflected in the present writer's work seeking to articulate more definitively the essential characteristics of the Misesian entrepreneur, and to demonstrate how

central these characteristics must be for an understanding of the competitive process. As one writer has put it, the “leitmotif” of this work has been that “the exploitation of the gains from trade will not take place automatically. To achieve the advantages of co-ordination through exchange requires first that these potential gains are noticed. The entrepreneurial role is to be ‘alert’ to as yet unexploited gains from trade” (Ricketts, 1992, p. 67).

Mainstream economics has of course always assumed that exploitation of gains from trade *will* take place automatically, as soon as the gains exceed the relevant costs. This assumes that all opportunities for winning pure gain are instantly perceived and exploited. It follows that the market outcomes, at any given instant, must necessarily be understood as embodying the fulfillment of the most exacting conditions for equilibrium. Each economic agent in the market must, at each instant, therefore be assumed *not* to be grasping for pure profit (since all such opportunities for pure profit have *already* been grasped and eliminated). This has forced mainstream microeconomics into a straitjacket in which all decisions being made at each instant are, somehow, automatically fully coordinated (“pre-reconciled”) with every other decision being made in the system. This has restricted modern microeconomics to strictly defined states of equilibrium. This has, in turn, had the consequence that the notion of *competition* has had to mean, not any process during which competing market participants struggle to get ahead of one another, but a state of affairs in which any such struggle is both unnecessary and inconceivable.

By liberating economics from the assumption that all opportunities for pure gain have already been captured, this Misesian-inspired perspective on markets permits us to see market processes as ones in which such opportunities—hitherto overlooked—come to be perceived and exploited. This has opened up an entirely fresh dimension for economic activity, a dimension necessarily missing from an equilibrium-bound microeconomics. This new dimension is that of entrepreneurial *alertness* and entrepreneurial discovery. Whereas traditional economics has operated in a framework in which outcomes can be attributed to either (or a mix of) (a) deliberate maximizing choice, or (b) pure luck, this entrepreneurial perspective draws our attention to a third possible (and, in general, necessary) source for observed outcomes. This third source is *discovery*, in which unfocused, unspecified, unpurposefulness—a generalized intentness

upon noticing the useful opportunities that may be present within one's field of vision—in fact yields discovered opportunities (which may then be subsequently exploited in maximizing choice fashion). Such discovery cannot itself be characterized as rational, maximizing choice (in the way in which deliberate cost-conscious *search* activity has been treated in the theory of information literature) because, prior to the moment of discovery, the potential discoverer is perceived not to have any specific search objective or search procedure in mind and is (therefore) not seen as weighing the likely benefits of a successful find against the costs of necessary search. (In fact his discovery may consist in *realizing* that he *has* before him a promising opportunity for profitable search.) Nor can a discovered opportunity be entirely attributed to pure luck. Although, to be sure, the objective existence of the opportunity itself (prior to its discovery but at a point in space and time likely to result in discovery) may (disregarding the philosophical reservations one may have concerning the “existence” of an unperceived opportunity) be seen as entirely a matter of luck, its discovery must, at least in part, be attributed to the alertness of the discoverer.

The notion of entrepreneurship as the alertness necessary for the discovery of opportunities has had important implications for the positive understanding of market processes, and for ethical judgments concerning the moral status of market outcomes. The positive theory of the competitive market process has come, in this line of modern Austrian economics, to mean the sequence of market trades and acts of production which can be attributed to the succession of entrepreneurial discoveries generated by disequilibrium conditions. To compete means, in this framework, to perceive an opportunity to serve the market better (than it is currently being served by one's competitors). This view of the function of the entrepreneur has been central to the modern Austrian appreciation of free markets, and to its understanding of the perils of interventionist public policies.

These Austrian insights concerning the role of entrepreneurial discovery have also revealed the *discovered* character of pure entrepreneurial profit. This has permitted an ethical view of the possible justice of such profit in a manner not open to mainstream economics (for which pure profit is likely to appear to have been enjoyed by the entrepreneur strictly as a matter of his good luck). This insight has been explored in Kirzner (1989).