

Journal Review:

Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach

Israel M. Kirzner

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“I think there is a world market for maybe five computers.”

- Thomas Watson, Chairman of IBM, 1943

I. Introduction

The earlier entrepreneurial error of Thomas Watson and IBM in 1943 creates profit opportunities for other alert entrepreneurs to discover in a free competitive market, thus pushing the market in the *equilibrative*¹ direction. This is the essence of the Kirzner’s market process approach which is part of the modern Austrian economics.

In the first half of the review, we *summarize* his article by overviewing the history of the approach, its contrast with the neoclassical, the development of the approach, its policy implications, its criticism, and some misunderstanding of the approach.

In the second half, we show that nothing is original from the Kirzner’s approach, in comparison with that of the neoclassical, with the *exception* of its sheer ignorance and surprise characters. These distinctive features give scope for imaginative and creative

¹ The market is systematically tending toward equilibrium, but guarantee no rapid (or slow) convergence

entrepreneurs to discover technological, sociological, and developmental disequilibrium by destroying old practices and creating new practices in the free competitive market process.

II. Overview of Entrepreneurial Discovery and Competitive Market Process

II.A. Modern Austrian Approach

The paper² discusses an approach within modern Austrian economics that emphasizes on microeconomics, but is different from that of (mainstream) neoclassical economics. This approach is not a widely accepted Austrian position, but key to revive contemporary interest in Austrian ideas as claimed by the author.

Early Austrian economics followed “subjectivist” tradition of Carl Menger, Eugen von Boehm-Bawerk, and Friedrich von Wieser that began in the late nineteenth century and was perceived as one branch of (mainstream) neoclassical approach until the 1930s. Beyond the 30s, Ludwig von Mises and Friedrich Hayek took away the Austrian tradition from the mainstream neoclassical microeconomics, consequently the tradition was ignored by the mainstream. But their contributions had revived Austrian economics in the past two decades with the emergence of a modern Austrian approach.

The modern approach explains what happens in market economies differently from neoclassical general equilibrium model where market is, at each and every instant, strictly equilibrium phenomena. Instead, it explains how *equilibrating tendencies* works from initial non-equilibrium conditions.

The author specifically focuses on the role of knowledge and discovery in the market equilibration process. In this systematic process, market participants acquire more and more accurate and complete mutual knowledge of potential demand and supply

² The word “the author” and “the paper” refer to Israel Kirzner and his article correspondingly.

attitudes. The driving force behind this process is what Kirzner called an *entrepreneurial discovery*.

The discovery involves *sheer ignorance* (i.e. unknown state) and *surprise* (i.e. realized one's ignorance aftermath) elements that are different from mainstream's imperfect knowledge (that introduces information searching cost). By discovering, market participants reduce the sheer ignorance, increase mutual awareness, and drive prices and quantities toward equilibrium. As the author puts it:

The dynamic competitive process of entrepreneurial discovery is one which is seen as *tending systematically toward*, rather than away from, the path to equilibrium. Therefore, the standard, competitive equilibrium model may be seen as more plausible as an *approximate outcome* ...

II.B. Austrian Criticism of Neoclassical

Kirzner elaborates this distinction further by criticizing neoclassical theory in terms of its equilibrium characteristics (at individual and market level) and its methodological foundation. At the individual level, maximizing decision makers³ in neoclassical has no open-ended character in their human choices and thus no scope for imagination and boldness. At the market level, already attained state of equilibrium at all times has no room for improvement and no available opportunities for grasp. Methodologically, neoclassical competitive markets in terms of Marshallian supply and demand diagram do not explain the equilibrating tendencies in the markets, because it denies the operation of competition in disequilibrium.

II.C. Development of Austrian Market Process

Then the author develops an alternative approach, the entrepreneurial discovery, which is derived from Mises' *entrepreneurially driven process* and Hayek's *role of knowledge*. Mises' focus on the market process allows profit seeking entrepreneurial

activities to take place in the market. Hayek's emphasis on the role of knowledge explains the market (equilibrating) process that involves imaginative and profit-seeking entrepreneurs in acquiring better mutual information in disequilibrium condition. Both perspectives include a concept of competition that is different from the one used in the neoclassical theory.

Neoclassical's competition follows the notion of perfect competition, where signs of rivalry are absent. Mises and Hayek view competition as dynamic rivalry among buyers or sellers, which is the character of the market process. This concept of *rivalrous competition* is interrelated with two other concepts of entrepreneurial discovery, *the entrepreneurial role* and *the role of discovery*. The author discusses each one separately.

The entrepreneurial role drives the ever-changing process of the market as the entrepreneur changes price/output data. Earlier entrepreneurial errors result in shortages and surpluses. Alert entrepreneur discovers these errors (profit opportunities), buys where prices are "too low" and sells where prices are "too high". Thus price discrepancies are narrowed in the equilibrative direction. This process does not guarantee rapid (or slow) convergence to equilibrium, but guarantee profit-incentives.

The role of discovery ensures that profit opportunities generated by earlier entrepreneurial error are not overlooked. The nature of the overlooked profit opportunity is that one is not aware at all that one has missed the grasping of the profit (sheer ignorance). So the entrepreneur has to stay alert at all times to prepare for discovery and surprises. This continual discovery is not a deliberate search, but also not a pure chance. It is somewhere in between. The result may lead to pure profit as well as pure losses. The nature of these market tendencies that pushes the market in the equilibrative direction.

³ including decision making under (Knightian) risk where decisions are made with *known* probability.

The rivalrous competition enables entrepreneurs to enter the market, to compete with others, and to outdo rivals with better deals (better products and/or prices). The competition reveals information that no one was aware of its having been lacking. It depends on the profit incentive to keep down the incidence of entrepreneurial error.

II.D. Applications of Austrian Approach

The author then applies the entrepreneurial discovery approach that has been discussed previously to antitrust policy, economic justice, welfare economics, and central planning under Socialism. For *antitrust policy*, Kirzner recommends a policy to guarantee free entrepreneurial entry into any market, instead of limiting firm size⁴, to induce entrepreneurial competition. For *Economic justice*, the discovery approach enables us to include not just a given pie (known-to-be-knowable) but also a discovered (wholly-unknown) pie in the income distribution discussion. The approach also has relevance in justifying pure entrepreneurial profit as discovered gains from entrepreneurial creation and discovery in the production sphere. For *welfare economics*, the author judges the economic success of a social system not just in terms of achieving the equilibrium with some degree of efficiency, but also in terms of how quickly and accurately we can identify the disequilibrium. Judging a tax policy for example, Austrian economists ask what is the impact of the policy on stimulating the entrepreneurial discovery, in addition to optimizing society's resources. For *central planning under Socialism*, Lange-Lerner "decentralized" solution to central planning where socialist managers utilize given centralized non-market prices to maximize residual, which then leads to central adjustment of the prices in response to surpluses and shortages, can not solve economic problem facing society. Because the socialist managers will not be able to exploit available opportunities from

relying on non-market “equilibrium” prices in a continual changing environment of tastes, resources, and technologies. The solution comes in entrepreneurial discovery under rivalrous disequilibrium condition.

II.E. Austrian Criticism of Entrepreneurial Discovery

Some modern Austrian economists, who emphasize the radical uncertainty of the future, criticize the entrepreneurial discovery approach in two aspects: equilibrative character, and systematic (mutual) learning character. Those who object the *equilibrative* character are not sure that the equilibrative forces are stronger than the disequilibrative forces, thus questioning the meaningfulness of any equilibrium concept at all. Those who disagree on the *systematic learning* character believe that market achieve coordination through resource prices or monetary calculation of profit/loss that is continually changing, which frustrate the equilibrating tendencies of the market process.

II.F. Misunderstanding of Austrian Approach

The author concludes the paper by relating an Austrian approach, such as the entrepreneurial discovery, to an uncompromised laissez faire policy. Although Austrian economics tends to favor market solutions, but to conclude that it endorses pure laissez faire is inaccurate. Entrepreneur does make errors. But these earlier errors create profit opportunities as incentive for other profit-seeking entrepreneurs to correct those errors. So this entrepreneurial discovery process continually ensures that no tendency for errors to be made, thus encouraging a tendency toward equilibrium. And government regulation (of the entrepreneurial activity) is likely to disrupt this coordinative tendency toward error-correction.

⁴ The author considers this practice anti-competitive because it block entrepreneurial entry.

III. Evaluation of Entrepreneurial Discovery and Competitive Market Process

III.A. Neoclassical Market Approach

Kirzner's criticism of neoclassical equilibrium feature is based on his assertion that mainstream always assumes *perfect competition* and *perfect knowledge*. Some economists, notably James Ahiakpor (July 2000), argue that this assertion misrepresents mainstream economics.

The Marshallian supply and demand curve simply reflects self-interested sellers looking for higher prices in order to offer more quantities for sale, and self-interested buyers looking for lower prices in order to purchase more quantities. Market participants conduct this bargain hunting with as much as their own knowledge, but no insistence of perfect knowledge.

Similarly with perfect competition, early neoclassical economists, such as Alfred Marshall and John Stuart Mill, discussed market equilibrium without such assumption. In fact what Alfred Marshall (1920) said was "free competition, or rather, freedom of industry and enterprise", and competition where "the racing of one person against another, with special reference to bidding for the sale or purchase of anything." This "free and active competition", as quoted by J.S. Mill (1965[c.1806-1873]), is actually very similar to "free entrepreneurial entry into any market" and "rivalrous competition" concept that Kirzner previously mentioned.

Kirzner's assertion that neoclassical always insists on *instantaneous equilibrium* as a market phenomenon is not completely true as well. Neoclassical economists introduce market and natural prices to explain *non-equilibrium condition* and *equilibrating tendencies* of the market.

Market price can deviate from the natural price, defined as long run average cost plus normal profits, in the short term. But the market has a permanent tendency to close this gap when the free competition (free entry to the market) condition holds. J.S. Mill (1965[c.1806-1873]) summarizes this approach at best:

If a [market] value different from the natural value be necessary to make the demand equal to the supply, the market value will deviate from the natural value; but only for a time; for the permanent tendency of supply is to conform itself to the demand which is found by experience to exist for the commodity when selling at its natural value. If the supply is either more or less than this, it is so accidentally, and affords either more or less than the ordinary rate of profit; which, under free and active competition, cannot long continue to the case.

The statement does pose some similarity to the equilibrating tendency approach that is suggested by Kirzner (1997).

What is missing from the neoclassical market approach is (Hayek's) *role of knowledge* to explain the market equilibrating process, which Kirzner elaborates into *entrepreneurial discovery* process involving sheer ignorance and surprises. These are the true originals and contributions of Austrian and Kirzner in explaining the market phenomenon. Specifically, Kirzner's entrepreneurial discovery approach enables an imaginative, creative, and alert entrepreneur as a central economic agent to destroy the old and create the new world of disequilibrium beyond the Neoclassical's equilibrating tendency of market and natural prices.

III.B. Technological, Sociological and Developmental Disequilibriums

Kirzner describes the disequilibrium as earlier entrepreneurial errors (profit opportunities) that are tended to be discovered by surprise. But disequilibrium can be technological, sociological, and developmental by nature (see Thurow, 1999). New disruptive technologies, such as microprocessor, create *technological disequilibrium* conditions for high-return, high growth opportunities to emerge. Microprocessor allows the personal computer (PC) to replace the mainframe as the dominant growth market in the

computer industry. The PC enables entrepreneur like Bill Gates to “discover” a new opportunity for each-PC-in-every-home that is driven by his desktop operating system.

Sometimes disequilibrium is sociological due to changes in demographics and human habit. Change in relative purchasing power of the elderly creates new opportunity for cruise vacation. Seventy-year-olds that twenty years earlier had cash incomes 40 percent below those of thirty-years-olds now had cash incomes 20 percent above those of thirty-years old. Cruise line entrepreneurs took advantage this *sociological disequilibrium* by discovering a perfect vacation for the elderly: “We move you; you don’t move.”

Opportunities also exist whenever there are high income-discrepancies among countries that allow entrepreneurs to replicate activities of the developed in the underdeveloped countries. For rich Hong Kong businessmen, a developed Vancouver is an economic desert in comparison to an underdeveloped China. Differences between China and the developed world creates *developmental disequilibrium* conditions that enable them to replicate what were low-rate-of-return and commodity operations in Vancouver were in fact high-return and high-growth prospects in China.

III.C. Creative Destruction

Alert entrepreneurs who discover the disequilibrium out of “sheer ignorance” may have to destroy the old while it is still successful and build the new before it is successful in the process. In other words, entrepreneurs have to tolerate *creative destruction* (Schumpeter, 1942) in order to stay alert and creative at all times for discovery and progress to take place. This paradox explains why Kirzner does not guarantee that discovery process will be rapid (or slow) convergence to equilibrium, but guarantee profit incentives.

Referring to our previous example of microprocessor, IBM understood early on this new technology and wanted to compete but could not destroy its old mainframe business to build the new one. The “sheer ignorance”⁵ of IBM allows other entrepreneurs, such as Scott McNealy of Sun Microsystems and Steve Job of Apple Computer, to discover mini (workstation) and desktop/home computers, thus correcting IBM’s entrepreneurial error.

Here we can see that free competition (freedom to enter the market) is a critical condition for creative destruction and entrepreneurial discovery process to maintain the equilibrating tendencies of the market. Without the free entry of Sun and Apple, IBM had less incentive to destroy the old mainframe and built a smaller and more powerful computer, and we probably got stuck with a big clunky machine for years. If this free competition condition holds, we are confident that the equilibrative forces are stronger than the disequilibrative forces in spite of the radical uncertainty in the future.

IV. Conclusion

Once we look closely at the neoclassical market approach, we discover its many similarities with the Kirzner’s equilibrating tendencies of the market and its rivalrous competition condition. What surprises us is the lack of explanation from the neoclassical about the imaginative and creative forces of the market that has to destroy the old and build the new in order to maintain the equilibrating tendencies character. Therefore we conclude that the Austrian market process in general and the Kirzner’s entrepreneurial discovery specifically, instead of contrasting, actually complement and enrich the neoclassical and the mainstream approach.

⁵ Although IBM were aware of the PC but were ignorant of the worthiness of it vis-à-vis the mainframe.

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