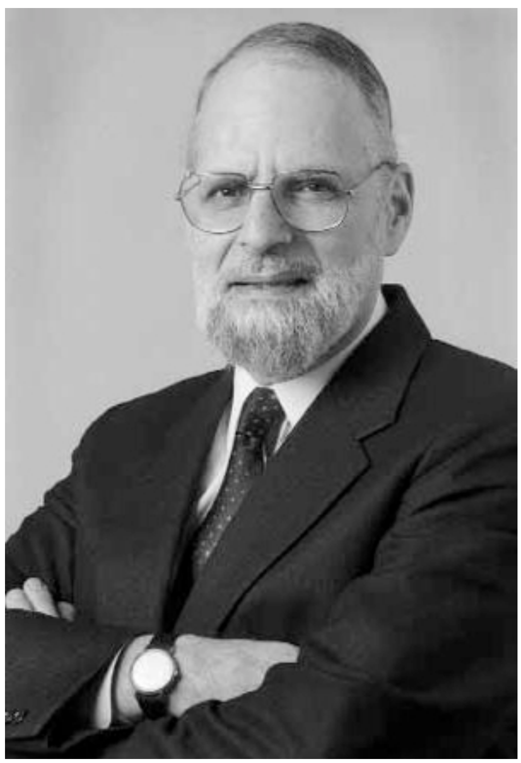
THE BEST OF THE OLL #19

Israel Kirzner, "Entrepreneurial Activity and the General Market Process" (1963)

"Entrepreneurial losses are incurred when producers make 'wrong' decisions; that is, whenever they use resources for purposes other than those that the market ranks as most important."



Israel Kirzner (1930-)

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[March, 2013]

Editor's Introduction

Israel Kirzner (1930-) is among the foremost scholars in the Austrian School of economic thought. If the first generation of 20th century Austrian economists were Ludwig von Mises (1881-1973) and Friedrich Hayek (1899-1992), Kirzner must be considered one of the leading members of the second generation, along with Murray Rothbard (1926-1995) who continued to develop Austrian insights in new directions. He studied at the University of Cape Town, the University of London, and received his PhD studying under Ludwig von Mises at New York University where he taught for many years. One of his major areas of research concerns the role of entrepreneurship in economic activity. Liberty Fund is publishing his *Collected Works* in 10 volumes.

Kirzner is best known for his work on the role of the entrepreneur as a key actor in the coordination of the market, that is to discover the best way to bring together relatively scarce resources to produce goods and services which are most in demand by consumers. When they succeed at this difficult task they are able to make profits. When they fail they make losses. One of Kirzner's key contributions to economic theory was to explain the process by which economic actors with imperfect knowledge of market conditions discover profit opportunities which did not exist before and take steps to realize those profits while at the same time satisfying the unmet needs of consumers. In his view there was no need to make unrealistic assumptions about all actors having perfect knowledge of static prices in a market which was in equilibrium.

In this section of his chapter on "The General Market Process" Kirzner provides an excellent summary of the 4 different ways in which entrepreneurs can take advantage of common disequilibrium conditions and thus bring about better coordination in the market: the discovery of more than one price for a good, producers who misjudge the importance consumers place on a given good, producers who misjudge the value of two different productive resources, and the fact that producers may not be aware of inventions or new techniques for producing certain goods. In a constantly changing world the entrepreneur plays an important role in seeing these opportunities for profit and thus bringing better coordination to the market.

"With respect to all these different kinds of inconsistencies among decisions, and the entrepreneurial activity they give rise to, we must not forget that entrepreneurs may not only gain profits but may also incur losses. In fact, whenever a market is not in equilibrium, some entrepreneurs are clearly forgoing (unintentionally, of course) more desirable opportunities for less desirable ones. Thus, in the broad sense, entrepreneurial loss is always present in a disequilibrium market. … Entrepreneurial mistakes are responsible for any subsequent disappointments in the plans of all market participants. However, the market contains a built-in device that operates to minimize the likelihood of entrepreneurial mistakes. This device is precisely the fact that such mistakes are inescapably accompanied by losses—that are, by definition, something entrepreneurs seek to avoid."

"Entrepreneurial Activity and the General Market Process" (1963)[1]

In this section we will discuss the various kinds of market forces that may be set into motion by entrepreneurial activity as a result of particular disequilibrium conditions.

"Entrepreneurs who find out this price discrepancy will simply buy the product or resource at the low price from those who do not know that any higher price can be obtained for it, and will sell at the higher price to those who do not know that it can be obtained at any lower price. In so doing entrepreneurs are wiping out a lack of coordination between decision makers."

1. Simplest of all will be the market agitation initiated by the discovery of more than one price for the same physical resource, or the same physical product. We have analyzed this already in Chapter 7. Entrepreneurs who find out this price discrepancy will simply buy the product or resource at the low price from those who do not know that any higher price can be obtained for it, and will sell at the higher price to those who do not know that it can be obtained at any lower price. In so doing entrepreneurs are wiping out a lack of coordination between decision makers. Among those who were aware only of the lower price, there were presumably some who might have sold more of the product or resource than they are prepared to sell at the lower price. Similarly, among those who knew only of the higher price, there were presumably some who might have bought a larger quantity had they known of the lower price. Entrepreneurial activity leading to a single intermediate price will remove this lack of coordination.

Of course, in considering a general market, we understand that the adjustment in the prices of the particular resource or product will affect market activity with respect to other products or resources as well. The nature of these secondary adjustments will depend on the particular relationships between the products or the resources. In general, the adjustments will follow the pattern we discuss below in the next few paragraphs.

2. A second possibility for entrepreneurial activity may be created by inconsistencies affecting most directly the decisions being made with respect to two different products. Ignoring the possibility of more than one price for the same physical resource, or the same physical product, there may be an absence of coordination among the production, selling, and buying decisions affecting two different products. This kind of inconsistency has already been noticed in this chapter, and it is, in addition, similar in some respects to cases considered in Chapter 7.

It may be possible, for example, that both consumers and entrepreneurs have each independently misjudged the relative significance that consumers attach to two particular products. As a result of this error consumers have adjusted their buying plans, and producers their production plans, according to the expectation of a price for the one product that is "too high," and a price for the second product that is "too low." Since all concerned make the same error, their price expectations prove initially correct. (We may imagine that the prices of the various resources, too, have become completely adjusted to the entrepreneurial plans constructed according to these expectations.) These production decisions are clearly inconsistent with each other in the light of prevailing consumer tastes. These production decisions would be mutually consistent only if the relative prices of the products would induce each consumer to allocate his income among the various available products in such a way that, in aggregate, consumers wish to buy precisely those quantities of each of the two products that producers have planned to produce. But if the market

[1]Israel M. Kirzner, *Market Theory and the Price System*. Edited and with an Introduction by Peter J. Boettke and Frédéric Sautet (Indianapolis: Liberty Fund, 2011). "Entrepreneurial Activity and the General Market Process" in Chapter 11: The General Market Process. <oll.libertyfund.org/title/2491/244785>.

price of the one product is too high, and the price of the other product too low, the terms of "exchange" between the two products are such that disappointments must necessarily occur. These terms of "exchange" between the two products will in general induce consumers to allocate income so that more of the second product is consumed in place of the first product than would have been the case with "correct" relative prices for the two products.[3] As a result producers of the first product discover that they have produced "too much" of it (that is, they find they cannot sell at the prevailing price all they have produced in expectation of this price); while producers of the second product discover that they have produced too little (that is, they are unable to satisfy all consumer orders made at the ruling price for their product).

It should be observed that the inconsistency among production decisions and consumption decisions relevant to the two products implies still further inconsistencies in decisions relevant to the resources allocated to these products. Although we have imagined resource prices to be completely adjusted to the plans of producers, the lack of coordination between the latter plans implicitly makes the decisions regarding the buying and selling of resources also internally inconsistent with each other in the light of consumer tastes. Thus, the adjustments that eventually will be brought about through the discovery of the fundamental inconsistencies in decisions with respect to the products will also exercise an influence upon the resource markets.

It is not difficult to perceive the opportunities for entrepreneurial activity created by these market inconsistencies. The entrepreneur who gathers the earliest information concerning the disappointed plans of the producers of the first product, and the disappointed plans of prospective consumers of the second product, is in a position to gain profits by exploiting his superior knowledge. He will refrain from producing the first product and will expand his output of the second product for which he will be able to ask and obtain a new higher price. In this way (assuming both products to use the same inputs) he will transfer resources from an employment where marginal revenue will be less than marginal cost (since he knows the price of the first product will fall, so that the equality between marginal revenue and marginal cost previously expected with the originally planned output will not be achieved), to an employment where marginal revenue will be greater than marginal cost (after the rise in price for the second product).

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Similarly, where the first product has been produced with resources different from those used for the second product, the more alert entrepreneurs will cut down their purchases of the resources used for the first factor and will expand their purchases of the resources used for the second. A tendency is thus caused toward a fall in the prices of the former resources and a rise in the prices of the latter resources. Profits are gained by these nimbler entrepreneurs because they perceive that they can obtain a high price for the second product. They see that resources hitherto thought able to create the greatest market value at the margin when allocated to produce other products (for example, the first product, perhaps) will in fact create the greatest market value when applied at the margin of production of the second product. Continuation of previous plans for the production of the first product must involve losses, they perceive earlier than others, at least on the marginal units produced. Their search for profits and fear of losses induces them to alter their decisions in the pattern described.[4]

Entrepreneurial activity will continue in this fashion for as long as the relevant decisions have not been shaken down into full mutual consistency. Prices of the products, quantities produced of the products, and prices of the resources affected must all be such as to eliminate plan disappointments. In a general market at any one time we may expect numerous groups of products (and these groups containing probably more than two products in each group) that will have the kind of inconsistency discussed here. In all such cases the market will be in agitation set off by entrepreneurial discovery of the profit possibilities thus presented.

3. A third possibility for entrepreneurial activity may be created by inconsistencies in market plans revealed most glaringly in the decisions affecting two different productive resources. We have seen, of course, that imperfection of knowledge in the market for products implies inconsistencies among decisions in the resource markets as well, and we have also seen that the resulting market forces will bring about corresponding changes in the decisions made in the resource markets. But there may be inconsistencies that have their root directly in resource market decisions.

Let us suppose that all resource owners and all entrepreneurs err in their assessment of the relative ease with which two different productive factors can be made available to the market; or that they err in their assessment of the relative usefulness of the two factors in the various branches of production open to the market as a whole. As a result of these errors, all concerned (correctly) expect prices for the resources that are "too high" for the first resource and "too low" for the second resource.

Presented with these market terms upon which the one resource can be substituted for the second, producers in aggregate ask to buy too much of the second resource and too little of the first, in comparison with the quantities of the two resources that their owners (in the light of the market terms upon which they can replace the one resource by the other in direct consumption) are offering for sale. We may assume that product prices are completely adjusted to the expected and initially realized resource prices, so that no entrepreneur sees any opportunity of improving his position from what he expects to gain by means of his production plans made in the light of the ruling resource and product prices.

Nevertheless, the resource prices are inconsistent with equilibrium conditions. Producers are induced by the relative prices of the two resources to produce definite quantities of various products requiring these resources, with methods of production calling in each case for an input mix with definite proportions of the various available resources. Resource owners are induced by the relative prices to sell definite quantities of the two resources. The aggregate quantity offered for sale of the second resource falls short of what producers are planning to use, while that offered for sale of the first resource is greater than what producers plan to use. The relatively high price of the first resource, as compared with the second, has led producers to plan production with methods substituting more of the second resource for the first, and to plan to produce more of those products requiring relatively heavy inputs of the second resource, and less of those products requiring relatively heavy inputs of the first resource. The relatively high price of the first resource may be inducing resource owners to substitute quantities of the second resource in direct consumption in place of quantities of the first.[5]

Some of the resource owners who have made plans to sell the first resource, and some of the producers who have made production plans calling for employment of the second resource, will find themselves disappointed. This is, of course, the direct result of the inconsistency between the decisions in the resource markets and will set into motion the appropriate corrective market forces. But the inconsistencies directly perceived in the resource market also imply indirect inconsistencies in the decisions made at the level of the product market. Consumers, we assumed, have been making consumption plans fully adjusted to the production plans that entrepreneurs have been making on the basis of *their* expected ability to buy all of each of the two resources that they might wish to buy at the expected prices. Since some of the plans of the producers are disappointed, some of the plans of consumers, too, are going to be disappointed (since these latter plans presuppose successful fulfillment of the former). The inconsistent plans of the producers are reflected here in the derived, inconsistent plans of the consumers.

This situation provides opportunity for entrepreneurial profits. As soon as some alert entrepreneur senses what is happening in the market for the two resources, he will immediately offer to buy quantities of the first resource at prices *lower* than the market prices prevailing initially. He will be able to secure these low prices, since resource owners will have been forced by their disappointments to revise downward their estimates of the price of the first resource. The alert entrepreneur will then apply his supply of the first factor to the production of those products that, requiring heavy inputs of the first factor, had been sold in the product market at correspondingly high prices. No consumers, until now, have been disappointed in their plans to buy products requiring heavy inputs of the first factor (since we have assumed the existing product prices to be completely adjusted to the output plans of the producers, and no producer who planned to buy the first factor has been disappointed). The price of the products requiring heavy inputs of the *first* factor, therefore, has no reason to fall. Thus, the alert entrepreneur who discovers the new lower price the first factor can now be obtained at is able to gain profits. Similarly, the discovery by the alert entrepreneur of the new lower price of the first factor (relative to that of the second, especially in view of the higher price that will certainly be charged very shortly for this second factor) may open up for him opportunities for profit through the substitution at the margin of units of the first factor in place of units of the second, in the production of those products using both factors.

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These profit possibilities have been made possible by the existing faulty allocation of resources. The "erroneous" market prices for the two resources had guided producers into substituting the second resource for the first in production, and into producing products requiring heavy use of the second resource in place of products requiring heavy use of the first—although, in view of the *real* factors underlying the market, a different pattern of production would have been more efficient. In view of consumer tastes, technological possibilities, and the willingness of resource owners to sell factors, the initially planned production pattern "wasted" the first resource and used the second resource too heavily.

As more and more entrepreneurs move in to exploit the profit possibilities thus created, they set into motion tendencies in price movements that both reflect the improving pattern of resource allocation and render more limited the possibilities for further profits. On the one hand, as entrepreneurs buy more of the first resource, and buy less of the second, they are directly easing the pressures that had been forcing the price of the first resource to fall, and that of the second to rise. At the same time, with the shift from the production of products requiring heavy inputs of the second resource toward products requiring heavy inputs of the first, a tendency is brought about for the price of the former products to rise, and for that of the latter products to fall.

We recognize, especially with respect to entrepreneurial activity set into motion by inconsistencies in the resource markets, that corrective adjustment may take considerable time to be completed. Even alert entrepreneurs may find themselves unable to exploit their earlier knowledge of market conditions, due to past decisions. They may be saddled with plants that cannot easily be converted from the production of one product to another, or from one method of production to another, or from one scale of output to another. What appear to be profits in the long-run view may not be profits in the short-run view (due to the differences in the respective opportunity costs). But eventually market forces will bring about the adjustments outlined above. Of course, in the general market we are dealing with, adjustments of this kind must be expected to bring about alterations in the conditions of related markets as well. These alterations, too, although they are likely to be of a smaller order of magnitude, will bring about adjustments that may be analyzed by one or other of the examples being considered here.

4. A fourth possibility for entrepreneurial activity may exist even where all resource and product prices are completely adjusted to the production and consumption plans that have actually been made. This possibility arises from the fact that these plans may not reflect the opportunities that "really" exist. Producers may be ignorant of particular inventions that might lower their costs; consumers may be ignorant of the way a new product may suit their given tastes.[6] In such cases resources are being used to produce goods that are less valuable than the goods that *could* be produced with the same resources, if the existing knowledge was fully exploited.[7]

Definite opportunities for entrepreneurial activity arise from circumstances of this kind. Disequilibrium conditions emerge as soon as someone perceives the profit possibilities inherent in the situation. He will then exploit these possibilities by applying the new invention to production (or by introducing the new product to the consumer market). The *innovator* (this term is used to distinguish him from the inventor) will then be able to produce products more cheaply than others, without having to sell these products at a lower price, or he may be able to produce a new product selling for a price greater than its full per-unit costs of production.

The market agitation set in motion in this way will gradually tend to subside as profit opportunities are exploited away. As knowledge of the new production possibilities spreads, the prices of resources, and of products, will adjust until equilibrium is restored, with no further opportunity for profitable entrepreneurial activity.

With respect to all these different kinds of inconsistencies among decisions, and the entrepreneurial activity they give rise to, we must not forget that entrepreneurs may not only gain profits but may also incur losses. In fact, whenever a market is not in equilibrium, some entrepreneurs are clearly forgoing (unintentionally, of course) more desirable opportunities for less desirable ones. Thus, in the broad sense, entrepreneurial loss is always present in a disequilibrium market. Entrepreneurial losses are incurred when producers make "wrong" decisions; that is, whenever they use resources for purposes other than those that the market ranks as most important. Entrepreneurial mistakes are due, of course, to mistaken assessments of market conditions. Even in a market where, like the model we are dealing with, the basic data—resource availability and consumer tastes—do not change, there is ample room for entrepreneurial mistakes. Entrepreneurial mistakes are responsible for any subsequent disappointments in the plans of all market participants. However, the market contains a built-in device that operates to minimize the likelihood of entrepreneurial mistakes. This device is precisely the fact that such mistakes are inescapably accompanied by losses—that are, by definition, something entrepreneurs seek to avoid.

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Notes

[3.] Where the two products are complementary goods, the direct consequences of the market error may be more complicated than is spelled out in the text.

[4.] The discussion in these paragraphs illustrates what were described in Ch. 2 as "horizontal relationships" existing among different sub-markets. The reader may work out for himself possible further developments that might follow (working horizontally) on the course of events described here. The reader may work out, for example, the consequences for the market prices of products that are used complementarily with one or other of the two products referred to in the text.

[5.] This will not necessarily be the case. For some resources especially, economists have learned to expect a "backward-sloping" supply curve. The high price obtained for the first resource may make it worthwhile for its owners to sell less of it, since the smaller quantity sold can command a "sufficient" range of purchasing power.

[6.] Clearly, a question of semantics is involved here. If one chooses to define tastes as referring only to those commodities that the consumer knows, then by definition a product that is still unknown cannot be described as an unseized consumer "opportunity." Nevertheless, the wider interpretation of "tastes" is in keeping with common usage.

[7.] Of course, the purist may point out that there are always unknown technological possibilities that future generations will discover. From this point of view a market system might be described as always in a state of disequilibrium, with respect to the infinity of knowledge that is beyond human reach. A more workable approach, however, is to define relevant technological knowledge as that which is possessed by someone in the system. Disequilibrium then exists, with respect to this knowledge, so long as it has not yet been placed at the service of the market.

Further Information

Source

The edition used for this extract: Israel M. Kirzner, *Market Theory and the Price System*. Edited and with an Introduction by Peter J. Boettke and Frédéric Sautet (Indianapolis: Liberty Fund, 2011). "Entrepreneurial Activity and the General Market Process" in Chapter 11: The General Market Process. <oll.libertyfund.org/title/2491/244785>.

Further Reading

Other works by Israel Kirzner (1930-) <oll.libertyfund.org/person/199>.

School of Thought: The Austrian School <oll.libertyfund.org/collection/8>

"The distinctive principle of Western social philosophy is individualism. It aims at the creation of a sphere in which the individual is free to think, to choose, and to act without being restrained by the interference of the social apparatus of coercion and oppression, the State."

[Ludwig von Mises, "Liberty and Property" (1958)]

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