CHAPTER 1

Entrepreneurship and the Market Process

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Why Entrepreneurship Is Important

In his 1964 presidential address to the Southern Economic Association membership, James Buchanan famously asked the provocative question "What should economists do?" Buchanan's question was explicitly motivated by his assessment that the discipline had gotten lost in doing "what economists do" without consideration of what would constitute scientific progress. More specifically, James Buchanan was advocating for an economics that would place the "theory of markets" rather than the "'theory of resource allocation' at center stage" (1964, p. 13) and return to Adam Smith's observation that there is a propensity in human nature to "truck, barter, and exchange one thing for another" (Smith 1776, p. 25).

The orthodoxy Buchanan was constructively critiquing was neoclassical price theory, which examines the patterns of equilibrium prices, costs,

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and output in different markets with specific emphasis on the allocation of resources in equilibrium. The goal of the price theoretical apparatus is to understand the requirements of general equilibrium, identify the paths toward equilibrium that price and quantity may take, and state the price and quantity combinations that will satisfy equilibrium conditions across different markets. In investigating the effects of government policy, price theory focuses on the changes in equilibrium price and quantity that changes in policy will bring about.

Lacking from orthodox price theory, in Buchanan's assessment, was a focus on "man's behavior in the market relationship [...] and the manifold variations in the structure that this relationship can take" (Buchanan 1964, p. 214). The alternative approach to studying economic behavior he proposed was explicitly focused on exchange relationships and the various forms they could take in both markets and politics. Buchanan's extension of this analytical focus to include spheres other than markets, and specifically politics, always assumed that individual behavior and cooperative relationships individuals engaged in depend on the rules of the game or the institutional structure in place to constrain individual behavior.

Buchanan was, of course, not alone in his critique of the path modern economics had taken throughout the beginning of the twentieth century. Israel Kirzner similarly argued that price theory was missing a description of how the actions of individual market participants interact to bring about changes in prices, quantities, and in the manner resources are allocated to competing uses (Kirzner 1973, p. 6). Price theory notoriously stresses that there are but three factors of production—land, labor, capital—to be optimized when making production decisions, but seems to take for granted who exactly is meant to do the optimizing. In Kirzner's own words, an analytical framework devoid of entrepreneurs "completely lacks the power to explain how prices, quantities and qualities of inputs and outputs are systematically changed during the market process" (1973, p. 42) and so cannot explain how the market equilibrates. Kirzner argued that in order for such considerations to enter the analysis, the analyst would have to shift her focus toward the competitive process and the role of the entrepreneur in perpetuating the competitive process. Crucially, entrepreneurship was the fourth factor of production missing from the neoclassical price theory.

Put differently and using the language of orthodox price theory, rather than focusing on the slope of the production possibilities frontier and its intersection with individual indifference curves, this market process perspective advocated by Buchanan and Kirzner (among others) analyzes how movements of the curve and pivots in its slope come about over time, what the institutional determinants of human action in markets and in politics are, and how exchange relationships change when institutions evolve.

Israel Kirzner specifically contributed to market process theory by introducing a theory of entrepreneurship that accounts for the differential alertness and awareness of entrepreneurs. More specifically, in Kirzner's model, entrepreneurs bring about the process of equilibration of market relationships by acquiring "more and more accurate and complete mutual knowledge of potential demand and supply attitudes" through entrepreneurial discovery (Kirzner 1997, p. 62). This discovery of information is the essential function entrepreneurs supply in the market process. They are alert to opportunities for arbitrage across space—as is the more traditional understanding of arbitrage—and time, and by acting upon those opportunities bring about changes in existing exchange relationships in the market. In doing so, they can, of course, commit errors, but the insistence upon the integration of an entrepreneurial perspective into the analysis of market relationships ensures a description of systemic adjustments to new and ever-changing information and constraints.

For Kirzner, incomplete and imperfect knowledge are facts of human life that lead to errors in decision-making in the market context all the time. For example, an entrepreneur may believe that her potential customers want to purchase her red shoes for $20 each, when in fact for the quantity she is producing, price should be closer to $30. Therefore, she may erroneously under charge for her shoes. However, alert market participants are able to recognize these sorts of errors with time. According to Kirzner, another person would likely notice the profit opportunity that emerges from the discrepancy between what she is charging and what her customers are willing to pay. That person may buy her shoes at the lower price she is charging and sell them at the higher price somewhere else. Processes like these drive markets toward equilibrium prices and quantities. In Kirzner's own words, writes, "the entrepreneurial element in the economic behavior of market participants consists … in their alertness to previously unnoticed changes in circumstances which may make it possible to get far more in exchange for whatever they have to offer than was hitherto possible" (1973, pp. 15–16).

While Kirzner develops his theory of entrepreneurship in the context of markets, the individual entrepreneur's alertness to differential opportunities for profit is essential in driving the process of entrepreneurial discovery not only in markets, but across different institutional settings. All cooperative and collective human endeavors, whether in the context of markets, politics, or society more generally require adjustment to and incorporation of new information into the institutional context in order to allow individuals that operate within this context to cooperate with each other successfully and go about the satisfaction of their individual wants and desires more effectively. The existing literature on entrepreneurship in politics and social organization more generally is multi-faceted and vast, but an entrepreneurial perspective has been applied to culture (Storr 2008; Storr and John 2011; John and Storr 2018), policy change and rent-seeking activities (Simmons et al. 2011; Coyne et al. 2010; DiLorenzo 1988; Holcombe 2002) institutional change in politics (Martin and Thomas 2013), non-profits (Haeffele and Storr 2019), how communities rebuild and revive following natural disasters (Chamlee-Wright and Storr 2010; Storr et al. 2016), and economic development (Chamlee-Wright 2002; Haeffele and Hobson 2019).

Economists of the Austrian school in particular have advanced Kirznerian ideas of entrepreneurship into studies of culture, community recovery, and politics. The driving question provided by Kirzner in many of these treatments is: What types of opportunities will entrepreneurs in various contexts be alert to? For example, Storr and John (2011), use Kirznerian theory to demonstrate how culture can shape entrepreneurial gaze. They posit that "culture will direct an entrepreneur's gaze as well as her ability to recognize certain opportunities as in fact opportunities" (p. 89). To demonstrate how entrepreneurs with different cultural backgrounds can be alert to different opportunities, the authors provide accounts of different of flavors entrepreneurship in Bahamas and in Trinidad and Tobago, and they connect these different flavors of contemporary entrepreneurship to each island's economic history. Based on prior experiences under slavery and colonial rule, today's Bahamian entrepreneurs have a "master pirate" side that is ever ready to hustle, trick, and swindle to make money, but also an "enterprising slave" side, that words diligently and honestly to attract business. In Trinidad and Tobago, where different ethnic groups had dissimilar experiences in the economy pre-and post-independence, some appear to be more alert to opportunities for commercial enterprise, while others tend to look to politics and the bureaucracy for economic advancement.

John and Storr (2018) also consider the role of culture through another popular notion of entrepreneurship discussed in Austrian theory—the Schumpeterian view. They argue that while alertness to/identification of a profit opportunity is the essential moment of entrepreneurship for Kirzner, for Schumpeter, it is the actual acting upon the opportunity that constitutes entrepreneurship. According to Schumpeter (1961, p. 66), the crucial entrepreneurial role is the carrying out of new "combinations" of the means of production, that is: creating new goods, improving the quality of existing goods, creating new methods of production, opening new markets, finding new supplies of resources, or discovering new ways to organize an industry. The authors contend that focusing on both the Kirznerian (seeing) and Schumpeterian (doing) views of entrepreneurship enables more fine-grained analysis of entrepreneurship. They observe that certain aspects of the cultural context and institutional environment in Trinidad and Tobago promote people's alertness to entrepreneurial opportunities there, while other cultural and institutional aspects dampen this alertness. The same is true for opportunity exploitation.

Regarding community recovery, again, a focus on the entrepreneur helps us to understand who will take up the charge of rebuilding communities, and what methods will or will not work for them. Chamlee-Wright and Storr (2010) examined the Vietnamese community in New Orleans following the devastation of Hurricane Katrina, finding that social entrepreneurship played an integral part in that community's ability to recover following the hurricane. Entrepreneurs steeped in the local context needed to be alert to needs of their fellow community members in order to "coordinate recovery efforts, lobby for essential government assistance and provide key information and services to help displaced residents return and rebuild their communities" (p. 154). One such social entrepreneur was the pastor of the Mary Queen of Vietnam Catholic Church, Father Vien, who provided leadership by continuing to hold mass, checking up on his congregants at evacuation sites, persuading them to return to the community, and facilitating their return.

An important question in political economy is whether the political domain is like the market domain in terms of its ability to use and generate knowledge, and to coordinate productive activity with efficiency.

Thomas and Thomas (2014) consider the limits of the application of insights from entrepreneurial process theory to politics, arguing that the absence of price signals in politics prevents the entrepreneurship theory from being fully applicable. However, the authors harness insights from James Buchanan to demonstrate that at the constitutional level of politics, where general rules of the political game must be selected, political entrepreneurship is certainly possible and may even be efficient. Salter and Wagner (2018) argue that one way in which political entrepreneurship may manifest is through competition or contestation over alternative interpretations of constitutional rules.

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The contributions to this edited volume all share in common a focus on this Kirznerian market process perspective. Contributions in Part I focus on theoretical extensions and critiques. Simon Bilo offers an extension of the Kirznerian theory of entrepreneurship, with particular application to conditions of economic recessions. Bilo argues that the systematic re-valuation of previously malinvested capital during a recession has significant effects on the relative alertness of entrepreneurs to different productive and unproductive investment entrepreneurial ventures and can result in either a re-allocation of the re-valued assets of a focus on relatively unproductive entrepreneurial opportunities in case of political intervention and targeted stimulus spending.

Keith Jakee and Stephen Jones provide a critique of the Kirznerian conception of entrepreneurship based on its reliance on neoclassical, marginal analysis, which, as they argue, is founded on several unrealistic assumptions and therefore not representative of true entrepreneurial choice. Jakee and Jones suggest that rather than using marginal analysis based on twice-differentiable isoquant and isocost curves, the study of entrepreneurial decision-making requires a focus on total costs and corner-solutions to adequately deal with the problems of indivisibility, static knowledge problems, radical uncertainty, and transaction costs.

Stephane Kouassi's chapter titled Conceptualization of a Kirznerian-Ethnic-Entrepreneur in Market Sociology offers an extension of the Kirznerian framework of entrepreneurship into the domain of culture, taking into consideration insights from contemporary sociology regarding the "cultural determinants of the process of identification, evaluation and exploitation of entrepreneurial opportunities." Kouassi's chapter offers a theoretical model for how cultural factors may systematically promote or hinder certain types of entrepreneurial discovery.

In his chapter titled Non-market Competition as a Discovery Procedure, David Lucas synthesizes the existing literature applying Austrian market process theory to non-market contexts. In doing so, Lucas is able to identify shared theoretical insights and shortcomings in this literature and point to potential areas for fruitful future inquiry, as well as potential stumbling blocks for the systematic application of the market process perspective to non-market contexts like politics, institutional development, cultural norms, and crime.

Part II offers various applied perspectives on entrepreneurship. Olga Nicoara provides an analysis of how an understanding of the quality of formal institutions along with cultural attitudes toward entrepreneurship influence the entrepreneurial decisions of immigrants. She argues that immigrants from countries with lower overall institutional quality and cultural attitudes that are less supportive of entrepreneurial ventures will be more likely to become innovative entrepreneurs once they migrate to countries with institutions and cultural attitudes more supportive of entrepreneurship generally.

John Dove's chapter, "Productive Entrepreneurship, Unproductive Entrepreneurship, and Public Sector Economic Development Restrictions: Understanding the Connections", offers an empirical analysis of Baumol's (1990) prediction of the institutional variability of the relative prevalence of the types of entrepreneurship that can be observed in a particular society at a given point in time. Baumol famously suggests that institutions can change the relative profitability and therefore the relative prevalence of productive market entrepreneurship as compared to unproductive and even destructive types of extractive political (rent-seeking) entrepreneurship. Dove's analysis uses several indices measuring the relative profitability of productive and unproductive entrepreneurship in different states from Sobel (2008) as well as an index measuring the extent to which states provide non-tax economic development incentives from Patrick (2014). His results confirm Baumol's theoretical prediction that institutional environments that offer greater rewards for non-productive entrepreneurship will generate more unproductive entrepreneurial activity.

Finally, examining the impact of regulatory policy on entrepreneurship, Liya Palagashvili, provides a potential theoretical explanation for the variability in new business starts across different industries, and more specifically for the concurrent empirical decline in new firm starts among main-street businesses and increase in new business starts among tech-startups.

Across and between the different contributions to this edited volume, the authors provide a rigorous and thorough assessment of both the limitations and the benefits of the entrepreneurial perspective to analysis of markets. We are grateful for their work and the synergies and overlaps that have developed across the different chapters over the last two years since they were first presented at a conference sponsored and organized by the Mercatus Center at George Mason University.

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