CHAPTER 7

EXPERTS AND ENTREPRENEURS

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ABSTRACT

This chapter conceptualizes the Kirznerian entrepreneur as performing a unique and crucial role of driving an open-ended market process. Entrepreneurial alertness is a theoretical concept that occurs prior to choice and consists of changing perceptions of prices and real resource constraints. This chapter emphasizes the role of subjective perception in both arbitraging and innovative entrepreneurship and develops a simple matrix to synthesize these dual roles. This unique epistemic position in the market process qualifies both the arbitraging and innovative entrepreneur as capable of performing functions that are nonreplicable by experts outside the system.

What people expect from the economists is beyond the power of any mortal man.
— Ludwig VonMises (1996 [1949], p. 871)

INTRODUCTION

Public policy routinely expects economists to make pronouncements, predictions, and evaluations about the future direction of economic indicators. Pundits and politicians ask economists for insights concerning

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the nature and direction of unemployment, inflation, business cycles, and the profits and losses of corporate firms. In practice, professional economists are often busy in government offices creating special interest legislation. They work in monetary institutions and bureaus constructing statistics. Pressure groups, think tanks, and private firms all employ economists to supply analysis and espouse opinions in support of particular policies on how to best direct the economic affairs of private people. Evidenced by the position and prevalence within our society, the public assumes economists are experts capable of steering economic progress.

Experts possess specialized knowledge of a subject beyond that of the average person. Often the expert's knowledge, techniques, and skills accord authority for eliciting a correct judgment over something for which others are ignorant. Entrepreneurs, on the other hand, are individuals whose knowledge and judgment afford them opportunities to discover new gain and serve as a driving force in social processes (Martin, 2011). Within the market process, these gains involve utilizing resources more productively. In the case of the economist, the subjects of his expertise are patterns of human production and exchange. What the economist has at his disposal are a set of tools that allow him to abstract from the complexities of the real world and identify patterns of economic action.

Expert observers of economic activity however are constrained to making generalized observations about patterns of behavior, what Hayek termed "pattern prediction." It is impossible for economists and planners to access all the relevant knowledge necessary to substitute a better plan for the judgments of entrepreneurs operating within a set of institutions that generate clear price signals. When it comes to the question of who has the expertise required to realize the most efficient use of resources and to steer the economy toward the most innovative advances in the market, the answer is the entrepreneur, not the expert. The economist is capable of explicating economic processes and characterizing states of equilibrium in the market. He can render intelligible the production and exchange decisions of agents within the economy and communicate to the public systematic and unintuitive economic regularities.

Economic experts cannot rationally plan the order market processes exhibit (Mises, 1920). The coordination that occurs independent of central command is the result of a system whereby rules generate information and incentives that particularly positioned individuals respond to in predictable and often productive ways. Entrepreneurs have the privileged epistemic positions capable of accessing their own creativity and preference rankings as well as the requisite local knowledge of time and place. Institutions of

private property then generate incentives to monitor changes in relative prices and the ability to perceive changes in the underlying and induced variables.

This chapter explores the relationship between expertise and entrepreneurship within the market process by examining the Kirznerian concept of entrepreneurial alertness. I argue the significance of the alertness concept is the importance it places on the subjective interpretations of individuals *within* market decision-making. The chapter utilizes this concept as it relates to arbitraging and innovative entrepreneurship in order to improve the characterization of the epistemic position of the entrepreneur. I argue improving our understanding of why entrepreneurs are coordinating mechanisms of the market should lead to greater skepticism of expert claims concerning the ability to improve on the knowledge generating properties of the market process. Finally, I conclude with implications as to why acknowledging the epistemic privilege of the entrepreneur within the market process may be a useful for how we view error, error correction, and progress within a non-teleological system (Hayek, 1973, pp. 38–39).

KIRZNERIAN ALERTNESS

Austrian market process theory is unique in emphasizing the explanations of market adjustments through entrepreneurial action. Izrael Kirzner's (1973) concept of entrepreneurial alertness is foundational to market process theory, providing a comprehensive treatment of how market participants come to coordinate their actions with one another. Foss and Klien (2010) provide three critiques of Kirznerian alertness. First, they suggest the concept is overly theoretical and argue that Kirzner's emphasis on the equilibrating role of the entrepreneur "reflects a particular, idiosyncratic reading of the Austrian price-theoretic tradition," one that is outside the causal realist tradition of Menger, Mises and Hayek. Second, Foss and Klein would prefer to substitute the concept of "judgment" to define entrepreneurship not "alertness or discovery, but as action under uncertainty" (2010, p. 3). Finally, they discuss inconsistencies in Kirzner's treatment of the antecedents of discovery, suggesting that Kirzner's own theory fails to justify the welfare conclusions he draws from it.

The perspective put forth by Foss and Klien (2010) presents some important critiques of the alertness framework. As such, the piece affords an opportunity to revisit the role of subjectivism in entrepreneurial action. Hayek (1979 [1952]) went as far as to suggest that "it is probably no

exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism'' (p. 52). The Kirznerian concept of alertness is a fundamental contribution incorporating subjectivism into economics, making it relevant to discussing Kirzner's theory of entrepreneurship within the Austrian price-theoretic tradition.

Kirznerian alertness cements subjectivism within a general theory of choice. Alertness begins with the assumption that all choice takes place under the conditions of uncertainty, so while it includes business decisions, it extends deeper to cover all areas of human decision-making. Foss and Klein claim that ''Kirznerian notion of alertness abstracts from uncertainty'' however Kirzner clearly states, ''a fully subjectivist treatment of choice must grapple with the way the decision maker, with all his spontaneous creativity in the face of a radically uncertain world, chooses which of the infinite possible pictures of the future he adopts as the basis for the alternative scenarios among which he undertakes to purse'' (1992, p. 126).

Koppl (2002) points out that Kirzner uses the term entrepreneurship in two ways – in developing the theory of market exchange and in reference to empirical events. First, when speaking about entrepreneurial alertness, Kirzner is situating the concept within a praxeological theory of human action. Here Kirzner defines alertness as being ''present in all human action an element which, although crucial to economizing, maximizing, or efficiency criteria, cannot itself be analyzed in [the same] terms'' (1973, p. 31). This *theoretical* understanding of entrepreneurial alertness is directly reflective of Mises (1996 [1949]) theoretical characterization that ''every actor is always an entrepreneur'' (p. 253) and ''[w]hat economics establishes with regard to entrepreneurs is rigidly valid for all members of the class'' (p. 61).

More generally, entrepreneurial alertness is an element within the very basic framework of Mises' theory of human action. For Mises, human action is purposive in pursing chosen goals or ends. However, individuals also possess the capacity of ''alertness to identify which ends to strive for and which means are available'' (Kirzner, 1973, p. 34). Mises theory of human action is thoughtfully subjective, ''including the insight that any ends-means framework relevant to a human action has itself been actively chosen in the course of that very action – and that choice expresses and reflects that agent's dreams, aspirations and imagination, his expectations and his knowledge, his hunches and his biases'' (Kirzner, 1992, p. 131). Clearly, alertness includes implicit or explicit judgment over one's own means-ends framework. This view challenges Foss and Klien's (2010)

conception that "judgment implies asset ownership" – suggesting that judgment occurs within an individual's mental model of the social world.

Both Mises and Hayek delineated between theory and applied economic analysis, and Kirzner in this respect is no different. Entrepreneurial alertness is a theoretical concept useful in guiding how we understand the realities of entrepreneurial action within the market process. In short, individuals' subjective perceptions matter for how resources are utilized and more importantly how these patterns of production and exchange change over time. Kirznerian alertness opens the door to "serendipitous changes" in relevant knowledge, emphasizes the importance of interpretation, and allowing for spontaneous discovery – all by first *theoretically* establishing a subjective moment prior to choice within the body of a general theory of market process.

Kirzner's concept of entrepreneurial alertness builds into the Misesian formulation the core ideas present in Hayek's work on knowledge. Kirzner (1973) defines alertness as "the 'knowledge' of where to find market data" (p. 67) whereby the data he is referring to are individual's subjective perceptions of real resources and the knowledge of where to find those data is the contextual local knowledge of time and place (Hayek, 1980 [1943]). The definitively subjective nature of the data and the localized constraints of time and place uniquely position the entrepreneur to perceive disparities in the underlying and induced variables.

What comes directly out of the market process and Austrian traditions is the thoroughly subjective view of how individuals within the system operate and how the price system works in conjunction with this fundamental feature of the human condition. By contrast, the neoclassical route adopted a set of tools for understanding this behavior that places an outside observer into the position of *defining the relevant variables* for the agents within the system. This process, while useful and nontrivial, masks the crucially human engine of the market process. In doing so, formalization lends itself to the interpretations of another – outside "expert" – mainly, the economist.

Individuals' access to local, contextual data means entrepreneurial alertness is both nonreplicable and nonrandom (Skarbek, 2009). Focusing on perception is important because it is the changing classification and definition of the underlying variables that is the catalyst to the entrepreneur undertaking actions that bring about higher degrees of coordination. As no one outside the system has access to these perceptions, the entrepreneur is in a particularly good position of expertise with regard to tacit and/or localized knowledge of time and place. Constructing the entrepreneur as

expert within the system of market processes clarifies the primacy of perception of economic goods, resources, and preferences.

TWO TYPES OF ENTREPRENEURSHIP

The literature on entrepreneurship often distinguishes between the innovative "Schumpeterian" entrepreneur and the "Kirznerian" arbitraging entrepreneur. In this view, the Kirznerian alertness is often associated with only those equilibrating movements in the market prices. As Foss and Klien note, Kirzner himself rejected the distinction One reason, perhaps, is that the alertness concept is easily applicable to both types of entrepreneurial actions.

Kirzner's theory of the market process has two types of entrepreneurial activity. The first is Kirzner's introduction of entrepreneurship into the closed framework of neoclassical equilibrium framework. Here the entrepreneur is engaging in the activities of "simple" arbitrage behavior. Entrepreneurs discover those gains from exchange that henceforth went previously undiscovered due to localized knowledge and constraints facing market actors. Within the highly stylized vacuum of the neoclassical model, this arbitraging behavior can occur instantaneously and costless.

The second concerns the more "complex" component of entrepreneurial activity whereby economic growth results from entrepreneurial actions that increases the scope and productive capacity of the market. This latter type of entrepreneurship involves the discovery of gains from exchange that previously did not exist. Innovative entrepreneurship is more complex in that changes in the underlying variables are must more difficult to detect because they are non-priced prior to discovery.

The distinction highlights a tension in Kirzner's writing between wanting to exemplify the importance of entrepreneurial actions within a closed framework of neoclassical models and to discuss the role of the entrepreneur as the central force behind the market process and economic growth. Arbitraging behavior and innovative discoveries are indistinguishable ex ante from the point of view of an expert outside the system. As such, Kirznerian alertness as a theoretical concept can be equally useful in thinking about these two entrepreneurial roles.

The unity Kirzner brings to the theory of market process through the concept of alertness is important and underappreciated in one primary

respect. The alertness concept provides a theoretical point of reference for understanding empirical phenomena that secures an emphasis on the subjective perceptions of localized areas of knowledge by individuals within their environment.

Foss and Klein (2010) suggest that Kirzner's work is overly theoretical and the Kirznerian entrepreneur "is simply a coordination device, and that is all" (p. 16). However, the process of mutual adjustment under uncertainty and ignorance – the coordinating properties of the market process set in motion by entrepreneurial action – are how markets allocate resources efficiently, exhaust gains from exchange, and encourage the discovery of new productive endeavors. The position advanced here is that alertness occurs in interpreting the world in such a way as to better map the subjective perceptions of real resources with the subjective demands of consumers. Entrepreneurial actions attempt to realize those interpretations, undertaking costly action in the face of uncertainty. This unique position to identify potentially coordinating moves is the epistemic privilege enjoyed by entrepreneurs and unavailable to economists, planners, and government officials.

Entrepreneurs bring the underlying variables (resources, technology, preferences for goods and services) into better alignment with each other by simultaneously interpreting what the underlying variables are in relations to adopted means-ends framework and recognizing differences in the induced variables (prices, quantities, and qualities). The matrix in Table 1 is useful in examining alertness as it pertains to both entrepreneurial acts of arbitrage and innovation.

Table 1. Arbitrage Entrepreneurship and Innovative Entrepreneurship.

Market Participants' Perceptions of:		Induced Variables	
		Unchanging	Changing
Underlying variables	Unchanging	Equilibrium (I)	Arbitrage entrepreneurship (II)
	Changing	Innovative entrepreneurship (III)	Indeterminate disequilibrium (IV)

The above matrix shows that when the underlying variables of resources, technology, and preferences map with the prevailing market prices, the two are dovetailing perfectly and the economy is in a state of

equilibrium. Quadrant I captures Hayek's (1949) definition of equilibrium whereby:

> … the foresight of the different members of the society is in a special sense correct. It must be correct in the sense that every person's plan is based on the expectation of just those actions of other people which those other people intend to perform and that all these plans are based on the expectation of the same set of external facts so that under certain conditions nobody will have any reason to change his plans. *Correct foresight is then not, as it has sometimes been understood, a precondition which must exist in order that equilibrium may be arrive at. It is rather the defining characteristic of a state of equilibrium.* (Hayek, 1945, p. 42, emphasis added when quoted by Kirzner, 2010, p. 62)

In other words, the subjective perceptions of economic actors are accurately reflecting the same set of facts. No changes are occurring in how individuals perceive the usefulness of real resources and no one is able to capitalize on price discrepancies.

In quadrant II, prices, quantities, qualities, or categories of goods are in some ways not reflecting the underlying variables – either prices are too high or too low – and as such, opportunities for arbitraging entrepreneurial action are said to exist. Producers or consumers can capitalize on their perceptions of these price discrepancies by buying near and selling dear. Successful arbitraging entrepreneurs are those who correctly anticipate the changing relationship between the induced prices and take actions to bring resources into realignment with those changes, thereby temporarily earning economic profits over and above the normal rates of return.

Quadrant III describes innovative entrepreneurship whereby the induced prices for a given state of resources, technology, and preferences for a defined set of goods are stable but a shift occurs in how individuals perceive an underlying variable. In this case, the innovative entrepreneurs are alert in two distinct ways. First, subjective perceptions lead innovators to discover resources or technology that previously did not yet exist nor factor into the market decisions of producers and consumers prior to discovery. Second, entrepreneurs are alert to new ways of categorizing or perceiving given underlying variables. In this case, an entrepreneur may come to redefine what resources constitute costs and how within a particular structuring of production.

Quadrant IV is indeterminate from the point of view of equilibrating tendencies. The existence, frequency and significance of these states of the world was of obvious concern to Kirzner and Lachmann. However, from the perspective of an extensive market with multitudes of entrepreneurial actors, there are strong reasons to suggest stability. Characterizing states of the world as either changing or unchanging, novel or routine, is a blunt

instrument. Koppl (2001) argues that the world is both regular in many aspects and novel in others, carving out a middle road between the extreme positions of Shultz and Shackle. Day to day to life requires stability in expectations, one of those being that the world is on some margins in flux. A person's stock of commonsense knowledge that they draw on largely contains general categorical classifications for much of what we experience. In fact, it is precisely because our perceptual classifications of our social and physical environment are relatively stable that acts of innovative entrepreneurship challenge these preconceived associations.

Note that quadrants II, III, and IV are all disequilibrium states. The purpose of viewing alertness through this framework is not to weigh in on the tendencies for markets to move prices toward long run equilibrium values, but rather to focus on the perceptual features of two types of entrepreneurship. Quadrants II and III both exhibit the properties of generating movements towards a more coordinated state of affairs. In both of these quadrants, the presence of individuals with particular knowledge of the localized conditions of which they are privy will generate movements toward an equilibrium as agents undertake actions to capitalize on new perceptions. The arbitraging entrepreneur generates changes in the market that move agents to restore an already potential equilibrium positions. The innovative entrepreneur acts to generate new potential equilibria and in doing so sets in motion changes in prices that trigger arbitraging entrepreneurship in the other markets. In other words, movements outward to new frontiers along the production possibilities frontier will set off a series of additional processes that generate a tightening of the social fabric of markets inside the production possibilities frontier. Innovative entrepreneurs perceiving changes in consumer preferences, real resource constraints, or identifying new technologically feasible combinations of production may frustrate the adjustment processes set in motion by profit-seeking arbitragers.

Quadrants II and III highlight the idea that the entire process of market adjustment, by way of the entrepreneur, is a knowledge transmitting process. The particular knowledge arbitraging and innovative entrepreneurs have at their disposal includes not only the local facts of the external world but also the private, sometimes tacit knowledge of their own preferences. The system of market adjustment is itself a structure that provides the incentives for each of the parts to coordinate. As such, when comparing the knowledge of the entrepreneur to the knowledge of an expert, the comparison should emphasize the process in which each are

embedded. How tight or loose the feedback mechanisms are will determine systematic success or failure in correcting errors and revealing potential improvements.

As entrepreneurs seek out profits through perceiving changes in the underlying and induced variables, not all entrepreneurs will be successful. In fact, most will perhaps fail. Arbitraging entrepreneurship is likely to be on net more successful because discovery occurs in context of market generate prices, a context whereby changes in the underlying variables are more easily identifiable. The feedback of profit and loss incentivizes entrepreneurs while providing information as to how actions can be undertaken to achieve greater coordination. Discovery of innovations, on the other hand, occurs in previously non-priced contexts. Here failures occur as imagined plans do not accord with the underlying variables.

Entrepreneurs within the market order make mistakes. These errors are critical to the market process because of the information they generate concerning how effectively producers are utilizing resources to meet competing ends. Errors reveal information about which plans are not working, information that is essential for entrepreneurs to figure out what cost structures, production plans, and products work. In other words, social learning can only occur when failures arise and are unobstructed from being corrected by further acts of entrepreneurship.

Pushing this outward into other applications, we can make use of this framework for discussing entrepreneurship outside of market contexts. In other non-priced spheres of social activity, entrepreneurs seek profits. Political arenas afford entrepreneurs with venues for creating new rents through the democratic process. In these cases, the epistemic positions of the entrepreneur may be similar in many respects to market entrepreneurs. The political entrepreneur will have access to heterogeneous, local knowledge and in attempting to seek profits by redistributing wealth, make costly attempts to rearrange resources for gain. The feedback mechanisms guiding and disciplining this form of entrepreneurship however are weak. Moreover, the underlying institutions lack private property rights protection, leading to political exchanges to be non-welfare enhancing. Finally, political entrepreneurial errors are not easily identifiable. With such a weak feedback that exists in democratic institutions and the fact that often the entrepreneur bears few costs directly, political entrepreneurship is wasteful in the process of discovery of new rents.

Thinking about the epistemic position of entrepreneurs within the ecology of open-ended market and social processes is useful to advancing the way social theorizing addresses questions of error and error correction. Experts

and entrepreneurs both make mistakes, but the contexts of those mistakes are very different. How the system copes with error will determine the degree and direction of coordination. The market system under a set of private property institutions generates a clear method of transmitting information through prices and supplying incentives for entrepreneurs to detect and correct error. The systems in which experts occupy places or authority or influence, should be judged on the basis of how well the institutions structure their information and incentives to produce the correct outcome (Koppl, 2005).

The simple matrix developed here serves as a topology of how the position of the entrepreneur with respect to underlying and induced variables allows for error identification and correction. In reality, entrepreneurs occupy heterogeneous positions for potential discovery. This means the nonrandom, nonreplicable nature of entrepreneurial judgment is an important distinguishing feature between entrepreneurs and experts. Alertness cannot be taught, expertise can. Institutions shape and influence these two types of entrepreneurship in concrete scenarios and impact the scope of entrepreneurial action.

CONCLUSION

Julian Simon (1981) called human ingenuity the "Ultimate Resource." The argument advanced here – that entrepreneurs have nonreplicable and nonrandom epistemic positions within the market order – emphasizes the idea that the creative capacity of individuals is unlimited. Entrepreneurship is fundamentally about individual subjective perceptions of how to utilize resources to meet the desires of one's fellow man through the extended order of exchange. The entrepreneurial engine is fundamentally one of human creativity within an environment of feedback and learning made possible by profit and loss. Entrepreneurial action involves leveraging creativity over how we define and delineate preferences and resources.

Examining how innovative and arbitraging entrepreneurs perceive price signals and changes in the underlying variables highlight the subjective character of the data on which entrepreneurs act. This analysis purposely highlights the potential of the entrepreneur and the limits of expertise within the market order. Nonetheless, the framework whereby entrepreneurs are alert to make discoveries and to exercise judgment over resources can be expanded to understand how similar processes operate in the political

or cultural contexts where the feedback for entrepreneurial action is much weaker. I have simply sought to clarify the characterization of two types of entrepreneurial action and demonstrate the significance of such epistemic positions relative to expertise, which is more commonly accorded authority.

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