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## Entrepreneurship and the Defense of Capitalism: An Examination of the Work of Israel Kirzner

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# Entrepreneurship and the Defense of Capitalism: An Examination of the Work of Israel Kirzner

Peter Lewin

## Abstract

Israel Kirzner has spent a career in articulating and refining concept of entrepreneurship; His work is indispensable for anyone seeking an understanding of the role of the entrepreneur in the economy. This paper provides a critical appreciation of this work, and considers how Kirzner's insights might feature in a defense of Capitalism in the post- Socialist world.

Israel Kirzner a consacré sa carrière à articuler et affiner le concept d'esprit d'entreprise. Ses travaux sont indispensables pour quiconque cherche à comprendre le rôle de l'entrepreneur dans l'économie. Cet article propose une évaluation critique de ces travaux, et examine dans quelle mesure la perspective kirznerienne peut représenter une défense du capitalisme dans le monde postsocialiste.

**KEYWORDS:** Entrepreneurship, Capitalism, Coordination, Comparative Systems

# ENTREPRENEURSHIP AND THE DEFENSE OF CAPITALISM: AN EXAMINATION OF THE WORK OF ISRAEL KIRZNER

Peter Lewin<sup>o</sup>

## 1. Introduction: types of defenses

For many years Professor Israel Kirzner has been studying the nature and implications of entrepreneurship.<sup>1</sup> In the course of this work entrepreneurship has featured as a key factor in the defense and promotion of the market system. It is probably no exaggeration to say that, for Kirzner, entrepreneurship is *the* defining characteristic of Capitalism, and the centerpiece of any defense.<sup>2</sup> What then is the nature of this defense?

The most common approach to the defense of Capitalism is the argument that it is “good for us.” In other words, one way or another the Capitalist system produces a set of outcomes that is manifestly superior to the outcomes produced by alternative types of social organization. The adoption of Capitalism has desirable consequences and, therefore, is desirable. To be sustainable this argument requires, first, that it can be shown that the stated consequences do indeed result, and, secondly, that the consequences are desirable.

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<sup>1</sup> Among others Kirzner-1973, Kirzner-1979, Kirzner-1985, Kirzner-1992, Kirzner-2000.

<sup>2</sup> In all of his work on entrepreneurship Kirzner has consistently maintained that he is merely spelling out the insights of his teacher and mentor Ludwig von Mises. What is new in Kirzner and whether his approach is consistent with that of Mises, are interesting questions beyond the scope of this paper. Kirzner's extensive career-long examination of entrepreneurship is surely original and notable for both its clarity and subtlety.

More specifically, Capitalism is usually associated with an increasing variety of goods and services available to the members of society, made possible by rapid technological advance, which results in improvements in lifestyle. Yet arguments abound that cast doubt either upon the validity of this association of events (or that it is exclusive to Capitalism) or upon its desirability. For example, there is a widespread belief that even if Capitalism does bring variety and prosperity, it does so only for a lucky few.<sup>3</sup> Alternatively, one may argue that the fruits of Capitalism are bitter, bringing with them alienation, materialism, exploitation and the like.

A second line of defense, one which sometimes seeks to deflect the discussion above, proceeds from a consideration of individual rights. The defense of *individual freedom and autonomy* can be shown, under certain plausible assumptions, to lead to an argument for private property and freedom of trade. A rights based approach would seem to render consequences irrelevant. The beneficial effects of Capitalism are incidental. Capitalism is good because it arises from morally justifiable institutions and social arrangements, ones that are consistent with individual freedom and the absence of coercion. Its validity does not depend on a judgment as to the existence or desirability of certain consequences, but rather on the validity of the processes and procedures it allows.

It has, to my mind, been convincingly shown that these two approaches cannot be kept entirely separate.<sup>4</sup> Moreover, a rights approach, upon examination, collapses quickly into the broadly consequentialist (or indirect utilitarian) approach of the first defense mentioned above.<sup>5</sup> After all, why do we value individual freedom and autonomy if not for the consequences its achievement has for individuals – their “well-being,” integrity, creativity, utility or what have you? Freedom of action is inevitably connected with its consequences for the actors and for others. And our valuing of freedom is inevitably (if sometimes tacitly) connected to its empirical/historical effects. No social system can be appraised solely from the point of view of fundamental rights considered in a vacuum.

Kirzner’s defense of Capitalism, proceeding from an understanding of the nature of entrepreneurship, sometimes seems to be a “rights-based” (Lockean) approach. The entrepreneur is a “creator” of value and is thus “entitled” to the fruits of his creation. Closer examination shows that, while Kirzner does indeed invoke the idea of rights, his defense is firmly grounded in his understanding of the consequences<sup>6</sup> of entrepreneurial action. In this paper I critically but appreciatively

<sup>3</sup> The famous debate about the efficacy of Socialism encompasses these issues, the defenders of the market arguing in effect that Socialism brings neither prosperity nor equality, while Capitalism brings prosperity and opportunity (equality being a false norm).

<sup>4</sup> Yeager-2001, Yeager-1985.

<sup>5</sup> See Yeager-2001

<sup>6</sup> See Kirzner-1979, chapters 11, 12 and 13.

examine the concept of entrepreneurship as envisaged by Kirzner and its role in an evaluation of Capitalism. Such an evaluation is seen to rest on an understanding of the functioning of entrepreneurial processes in market systems and an appreciation of the generally beneficial consequences that result.

## 2. What is entrepreneurship?

According to Kirzner, an entrepreneur is someone who notices hitherto unperceived opportunities for gain. One who is alert to such opportunities is thus likely to be a better entrepreneur than one who is not. These opportunities are of many kinds. To some degree we are all entrepreneurs. The observation of a discrepancy in the price of a good (categorically the same good) in two different places suggests the opportunity to buy at the lower and sell at the higher price. The same is true of a perceived “undervaluation” of any good – presenting the opportunity to buy it now and sell it profitably later (assuming it can be carried through time, or that an option to buy it later at today’s price can be purchased). And, most importantly, an entrepreneurial opportunity exists whenever inputs can be bought (or rented) and used to produce an output of greater market value (due account being taken of interest as a cost of production). In all these cases exploiting the opportunities (if they are real and not just imagined) will lead to entrepreneurial *profit*. Profits are thus the reward for correctly perceiving and exploiting available opportunities.

Kirzner has developed some interesting implications of this approach. First, the entrepreneurial function must be sharply distinguished from that of the producer or manager. Though in practice successful entrepreneurs are often managers and producers, they are coincidentally combining these two functions in one person. In principle they could be, and often are, found in separate people. The entrepreneurial function consists in providing the “vision,” the insight as to what can and must be done. Once the opportunity has been revealed the entrepreneurial work is done. Implementing the vision may involve calculation, sequencing, monitoring and so on. But insofar as the opportunity is already perceived the entrepreneurial aspect is over.

Second, entrepreneurship is thus “costless.” Something which is “costly” can be bought and allocated to consumption or production. Its purchase requires a decision, a choice. A sacrifice must be made. This is what economists usually understand by the term “cost.” The cost of something is what you consciously have to give up to get it.

“In using any quantity of a scarce resource ... the decision-maker is always viewed as choosing between alternative goals to which the scarce resource may be applied. The goal forgone is the cost of using the resource for its present purpose. In the use of entrepreneurial alertness, however, a decision-maker never considers whether to apply some given potential alertness to the discovery of opportunity A or opportunity B ... [O]pportunities ... are either perceived or not perceived; alertness is not

something about which a decision can be made *not* to deploy it .... To recognize that opportunity A exists need not preclude simultaneously recognizing that opportunity B exists.”.<sup>7</sup>

Third, entrepreneurship depends on error. An opportunity for profit exists only if it has not already been noticed. In a sense, it reflects a “hole in the market.” The market values of products and resources do not reflect the value of the unnoticed opportunity. If it suddenly became widely known that certain resources could be more profitably used than they have been until now, their market value would rise immediately. Similarly, if the price of a commodity differed in two locations by more than the transportation cost, widespread knowledge of this would immediately result in the disappearance of the price discrepancy (net of transportation costs). In both cases sellers and buyers would immediately revalue the resources and commodities to reflect the opportunities for production and resale. An unexploited, unnoticed opportunity thus, by definition, reflects a market error.

It follows, finally, that entrepreneurial alertness performs a crucial coordination role in the market. For by noticing opportunities, entrepreneurs cause these market errors to be removed. And the removal of error results in the creation of wealth by improving efficiency in the production of existing products and by introducing new products (alerting producers to “best practices” and revealing new ways of combining resources). The coordinating function of the entrepreneur bolsters the dynamism of the market process in that opportunities are often serially and spatially complementary – earlier successful entrepreneurial opportunities give rise to subsequent ones that depend and build upon them. Economic growth as we know it is inconceivable without this entrepreneurial process.

It is important to stress that entrepreneurs become aware of new opportunities in a way that cannot be predicted (or else the opportunities would already be known). So, the process of coordination in the market facilitated by the entrepreneur is, of necessity, a decentralized, unplanned (organic, spontaneous) one. It is not a process that can be centralized in any planning bureau.

Kirzner’s view of the nature of entrepreneurship and of the entrepreneurial process thus implies a rich defense of the market system. Only in such a system will the seeds of entrepreneurial alertness bear fruit. Only in such a system can the

<sup>7</sup> Kirzner-1980, p. 24. This is closely related to the well-known critique of neoclassical search theory. Marginal maximization calculus cannot coherently be applied to the allocation of effort in search of benefits the value of which will be revealed by the results of that search. Such an application would presume to know the results of the search, thus rendering it unnecessary. And this is an instance of a set of general problems in which the value of today’s efforts will depend upon events yet to be revealed, and the knowledge that they bring. In Popper’s terms, we cannot coherently imagine having knowledge of future knowledge. The value of an entrepreneurial opportunity obviously cannot be known before it is perceived. One cannot, therefore, efficiently rationally allocate effort toward its perception. Yet clearly effort is allocated toward activities whose payoff cannot be known, as in the case of R&D. Some weighing of the value of efforts in this regard must be taking place. Kirzner’s characterization of entrepreneurship as costless thus bears further examination. This is provided in the next section.

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decentralized, often unarticulated bits of information come spontaneously together to result in ever expanding production and consumption opportunities. Clearly this echoes and reinforces Friedrich Hayek's insight that market systems are dependent on a "division of knowledge" that underpins the extensive division of labor.<sup>8</sup> But Kirzner's point is relevant also to the *incentives* that operate in different types of social systems. Only in a market system is it in the interest of the entrepreneur to notice a profit opportunity and "human beings tend to notice that which it is in their interest to notice".<sup>9</sup> In the absence of private property or of some mechanism for evaluating productive resources the entrepreneurial process could not work. This process depends on freely changeable prices to reveal opportunities and on the ability to exploit those opportunities. In a non-market system (or even a highly regulated one) planners and bureaucrats would have to be alert to these opportunities. They would be noticed only with extreme difficulty. Even if they were noticed planners and regulators have no direct incentive to exploit them or bring them to the notice of those who do.

Thus, although entrepreneurship is not a resource in the usual sense, it is a function that is crucial to the market process and one that can exist fully only within such a system.

### 3. Some aspects of entrepreneurship critically considered

The perception of entrepreneurship as something that is costless, spontaneous and crucial to the market system, raises some interesting difficulties. In particular, it provokes the questions: How does entrepreneurship arise? Where does it come from? It is basic to Kirzner's notion of entrepreneurship that it is not produced in the usual sense. Yet Kirzner wants to maintain that certain conditions (namely free markets) facilitate its emergence. Can we then say that Capitalism "produces" entrepreneurs?

One possible response is the assertion that entrepreneurship is intrinsic to human nature – not to the same extent in all human beings, but, nevertheless, a basic trait. The tendency to "truck and barter" referred to by Adam Smith, can be seen as a reflection of the basic (instinctual?) desire and ability to make a profit. Entrepreneurship then is not "produced" by Capitalism, it exists always, perhaps in latent form, waiting to be tapped by the right set of conditions.

There is some considerable appeal in this approach. Casual observations of different social conditions across time and space suggests that a resilient entrepreneurial spirit resides eternal in the human breast. Indeed, it appears that it is not something that is confined to people of a certain culture, social background,

<sup>8</sup> Hayek-1945.

<sup>9</sup> Kirzner-1980, p. 28.

education or any other acquired characteristic. People moving between societies (for example from non-market to market societies) often turn out to be outstanding entrepreneurs.

Yet, this way out is after all still unsatisfactory. First, it strikes one clearly as a transparent semantic trick. If Capitalism brings out the best of the latent entrepreneurial spirits, then, in meaningful sense, one can “produce” entrepreneurs by allowing Capitalism. In principle, one can conceive of the decision-making leaders of a society making a decision, *a choice*, to allow the development of free market institutions at the expense of socialist ones or vice versa, thus opting for entrepreneurial emergence or suppression. From this point of view entrepreneurship is indeed the result of a choice. How then can it be “costless?”

Nor does it help to argue that entrepreneurship occurs only at the instant that the opportunity is perceived and not before or after. True, realizing this does mean that entrepreneurship cannot be thought of as a resource – a stock of abilities that can be added to or subtracted from. But, insofar as more entrepreneurial instants occur in the presence of certain chosen conditions our problem remains.

There is a second, more important, aspect of this problem. While clearly “pure” entrepreneurship cannot be produced, in the usual sense of the term, and cannot be predicted, is entrepreneurial ability not predictably related to certain characteristics that are definitely produced? For example, is the ability to read and write not necessary to perceive certain types of opportunities? What about arithmetic – the ability to calculate? These abilities are produced. They are the products of a conscious human capital investment decision.

My purpose here is not so much to object to Kirzner’s way of characterizing entrepreneurship as costless, as to try to understand how the entrepreneur actually functions and to guard against any misconceptions that this characterization may occasion. It seems clear that, whether or not we characterize entrepreneurship as a scarce resource, it can be facilitated and nurtured by certain conditions. While individual opportunities obviously cannot be predicted, the emergence of opportunities (as a category) surely can be said to be more likely under some circumstances than others. And this insight is important for any evaluation of the market system. As explained above, entrepreneurship is crucial for the coordination of social activity. I examine this more closely in the next section.

#### **4. Entrepreneurship and coordination**

Social coordination is not an easy idea to define or understand. Analogies sometimes help. Driving activity is, for the most part, coordinated. What we mean by this is that people manage to get to where they had planned to go at around the time they planned to arrive. Coordination is about the mutual fulfillment of individual plans. How does this happen? In the case of traffic, people fulfill their travel plans because they have knowledge, gained from past experience (their own and others) and from education, about appropriate routes and because they respond appropriately (in a way everyone expects) to certain signals (traffic signals).



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Everyone interprets green as “go” and red as “stop”; everyone understands the meaning of a yield sign, etc. (Imagine if different interpretations were possible!) Discoordination is easily understood – it occurs when two vehicles attempt to occupy the same space at the same time. It is a situation where plans conflict. A traffic jam, occasioning late arrival, is a less extreme conflict.<sup>10</sup>

Relating this to social action in general, and economic activity in particular, we see social coordination as occurring where people fulfill their plans. Discoordination is obviously more likely than in the case of traffic, simply because *the signals are not as easy to interpret*. (Does a price rise mean buy or sell?) The information on which action is based is of a radically different type than in the traffic case.

To return to Hayek’s divisions of knowledge, we may say that people use “information” to acquire “knowledge”.<sup>11</sup> The knowledge that people use may be specialized and unconscious (tacit). It is frequently not “shared” knowledge. In this way the knowledge used by the economic system as a whole is much greater and more diverse than the knowledge that could ever be available to a single human mind. For example, knowledge may be of a “how to” or “what to” variety. Both are relevant to the entrepreneurial process – knowledge of what to produce, with what methods, where to produce it, etc. “How to” knowledge is often like knowledge about traffic signals. If you’ve been there once you know the way. You need only be told once that green means “go.” One observation that a left turn signal precedes a green light is usually sufficient to plant the expectation that this is usually likely to happen and so sharpen the response. Similarly, knowledge of how to produce a product with a standard technology or complete a routine task can be gained once and for all. There is stable feedback. But knowledge of when to invest, where to invest, what to produce, etc. is more akin to “belief” than knowledge. The signals are not unambiguously green or red. Collisions are likely, but not always obvious when they occur (at what point is a venture judged a failure?). Yet the market is just as dependent upon this type of (correct) knowledge than any other type. What guarantee is there the entrepreneurial decisions will indeed be coordinating and not discoordinating?

One may appeal to the law of large numbers. The market acts as a filter on bad (unsustainable) entrepreneurial decisions. Feedback is not entirely stable and it is not rapid, but it does occur. The mere existence of an economy with a growing variety of goods and services lends empirical support to the idea that the “right” entrepreneurial decisions dominate the “wrong” ones (though one must be careful not to let this become a tautology). But can we say *as a matter of logic* that this is so, that entrepreneurial action is, by its very nature, coordinating? Kirzner thinks we can.

<sup>10</sup> Interestingly Kirzner has independently used the traffic analogy in an article published in 1984 (see Kirzner-1992, chapter 8, especially pp.140-143).

<sup>11</sup> See Lewin-1994.

“Our identification of decision making with alert, entrepreneurial human action has provided us with *an explanation for the market process that does not, in principle, depend for its general pattern, upon any extra economic factual considerations whatsoever*. The market process emerges as the necessary implication of the circumstances that people act, and that in their actions they err, discover their errors, and tend to revise their actions in a direction likely to be less erroneous than before”.<sup>12</sup>

One may wonder about the meaning of the word “likely” in the above quotation insofar as it seems to invoke “empirical” knowledge, but we may leave that aside for the moment. The assertion that entrepreneurial action is equilibrating (coordinating – tending to bring about greater mutual fulfillment of individual plans) is here said to be a direct implication of the assertion that people learn (gain knowledge) from their mistakes. Yet, as we have seen, the knowledge of which we are talking is unlikely to be amenable to this type of learning. The feedback signals are not clear. Each entrepreneurial decision is unique in an important way (essentially unrepeatable). It would seem to me that the question of equilibration is ultimately an historical/empirical one.

This issue is one that with which Kirzner has wrestled throughout his career in his work on entrepreneurship — primarily in response to the protracted friendly debate that he had with his (now deceased) colleague Ludwig Lachmann.<sup>13</sup> The debate remains unresolved, though Kirzner *has* made numerous attempts to restate his ideas in a way that would be acceptable to those doubting the *logical* inevitability of equilibration.<sup>14</sup> Most recently,

“The logic of economics reveals not only what men will do in specific situations of perceived possible gain, but also the circumstance that men will tend to discover opportunities for gain generated by earlier errors by market participants (errors expressed in their failure to perceive existing price differentials). In other words, in explaining the source of profit opportunities in the entrepreneurial errors made at any given moment, economics is, *in that very explanation*, also identifying the scope of the tendency of real-world entrepreneurs to discover and exploit pure profit opportunities. *The equilibrating process is seen as implied, in the general sense, in the very notion of human action*. To be sure, in order to track the specific path of an equilibrating process more is required than the a priori logic of human action. But to articulate the central theorems of economics (which depend crucially, but only in a most general way, upon equilibrating tendencies) nothing more is needed than the pure logic of human action”.<sup>15</sup>

<sup>12</sup> Kirzner-1979, p. 30, italics original.

<sup>13</sup> For a summary assessment see Lewin-1999, chapter 2.

<sup>14</sup> See Kirzner-1992, chapters 1 and 8.

<sup>15</sup> Kirzner-2001, p. 87, second set of italics added.

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The precise meaning of the above quotation is not obvious to me, but, it does appear as if Kirzner may be including equilibration within the very *definition* of entrepreneurship – *i.e. defining* entrepreneurship as equilibrating.

Certainly there is a defensible sense in which all individual human action is equilibrating. In this sense equilibrating means simply that action is the matching of (perceived) means to ends – it is purposeful, therefore understandable. But one cannot logically go from this, from the assertion that individuals act to ensure a consistency between their ends and the means they have to achieve them, to an assertion that in so acting they tend to promote an overall consistency between individual actions. In a world of unstable feedback, on open ended world, actions by some individuals will frustrate the actions of others – actions generate failures as well as successes. So the issue remains unresolved. This does not detract in any way, however, from the importance of Kirzner's penetrating exposition of the nature of entrepreneurship. In fact, understood as an analysis of the logic of entrepreneurship applied to real world situations it provides a compelling defense of the market.

### 5. The defense of Capitalism

The observation that Capitalism is a system that tends to provide individuals with greater plan satisfaction is ultimately both an historical judgement and a normative judgement approving of the general pattern of outcomes that have been associated with it. Mistakes are made, failures experienced. A defense of Capitalism may contain the assertion that the degree of potential failure must surely be more limited than in the case of a centralized economy subject to one central plan. A "capitalist" economy is not necessarily one characterized by large amounts of capital or many capitalists. The defining characteristic must be the existence of entrepreneurship. For it is the presence or absence of entrepreneurial entry and exit that makes the difference.

To focus on the entrepreneur and the results of his actions as the key factor would thus seem to provide a defense of Capitalism based squarely on consequences. So be it. In the light of the history of the twentieth century it is a most powerful and telling defense.

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