

# Entrepreneurship from an Austrian Economics Perspective

A Focus on Israel Kirzner, Frank Knight, Joseph Schumpeter, and the Market Process

# Today's Roadmap

- 1 The Problem: Why did economics lose the entrepreneur?
- 2 Historical Foundations: Cantillon, Say, Menger
- 3 Frank Knight: Uncertainty and Profit
- 4 Joseph Schumpeter: Creative Destruction
- 5 Ludwig von Mises: Human Action and Calculation
- 6 Israel Kirzner: Alertness and Discovery (MAIN FOCUS)
- 7 F.A. Hayek: Knowledge and Coordination
- 8 Synthesis: Austrian Principles and Policy

# The Problem: The Disappeared Entrepreneur

## **Neoclassical economics assumes:**

- Perfect information
- Known production functions
- Equilibrium as the norm
- Rational optimization

## **Result: No role for the entrepreneur!**

*Where is the person who notices opportunities?*

*Where is the innovator who breaks equilibrium?*

# Austrian Economics: Bringing Back the Entrepreneur

## **Austrian approach focuses on:**

- Individual human action
- Genuine uncertainty
- Market process (not equilibrium)
- Subjective knowledge
- Coordination through prices

**The entrepreneur is central to understanding how markets actually work!**

# Richard Cantillon (1755): The First Entrepreneur

## Key insight:

- Entrepreneurs **BUY** at known prices
- Entrepreneurs **SELL** at unknown future prices
- The gap between them is profit

*Cantillon: "The entrepreneur bears the risk"*

This is the bridge between uncertainty and profit

# Jean-Baptiste Say (1803): The Entrepreneur as Coordinator

## **Say identified four functions:**

- Scientific knowledge
- Judgment and moral courage
- Perseverance and leadership
- Supervision of production

**Result:** A more expansive view than Cantillon

**The entrepreneur coordinates economic activity**

# Carl Menger & the Austrian School (1871): Subjective Value Theory

## **Menger's revolution:**

- Value is subjective, not objective
- Individual choice and action matter
- Marginal utility, not labor theory of value

## **Why this matters for entrepreneurship:**

Entrepreneurs act based on subjective expectations of what consumers value

# Frank Knight (1921): The Fundamental Question

## **Knight's Problem:**

In perfect competition with perfect information, **WHY would there be ANY profit?**

Traditional answer: Return to capital, management, risk

**Knight's answer: UNCERTAINTY**

**Profit is the reward for bearing genuine uncertainty**

# Knight: Risk vs. Uncertainty

## **RISK (Measurable):**

- Known probability distributions
- Can be insured or hedged
- Examples: mortality rates, dice rolls

## **UNCERTAINTY (Unmeasurable):**

- No basis for probability calculation
- Cannot be insured
- “Brute facts” of human activity
- Examples: new business success, war, innovation

# Knight: Business Judgment

## **Knight's Key Quote:**

*"Business judgment is chiefly judgment of men"*

## **Entrepreneurship is fundamentally about:**

- Forming expectations about an uncertain future
- Making decisions on these expectations
- Bearing the consequences

**Profit = Reward for better judgment**

# Joseph Schumpeter (1911-1942)

**Schumpeter's Question:**  
**What CAUSES economic change?**

Not marginal adjustments to equilibrium

Not passive response to market signals

**Something more: INNOVATION**

*"The fundamental impulse that sets and keeps the capitalist engine in motion"*

# Schumpeter's Five Types of Innovation

- ① **NEW PRODUCTS** — Creating goods consumers have never experienced
- ② **NEW PRODUCTION METHODS** — More efficient ways to produce
- ③ **NEW MARKETS** — Opening entirely new markets or business models
- ④ **NEW SUPPLY SOURCES** — Finding new raw materials or resources
- ⑤ **NEW ORGANIZATION** — Restructuring industries or creating monopolies

# Creative Destruction

## **Schumpeter's Most Famous Concept:**

*"The perennial gale of creative destruction"*

## **How capitalism works:**

- Old firms, products, methods are destroyed
- New firms, products, methods are created
- This process is continuous and dynamic
- Disruption IS the feature, not a bug

**Outcome:** Economic growth and progress

# Schumpeter's Entrepreneur

## Key characteristics:

- Not motivated by profit (at first)
- Seeks to establish dynasty/be a pioneer
- Has vision to “force products onto market”
- Breaks equilibrium
- Creates temporary monopoly rents from innovation

## The Schumpeterian entrepreneur:

**DISRUPTS, CREATES, LEADS**

Not just responds to market signals

# The Austrian Critique of Schumpeter

**Schumpeter's innovation theory is powerful BUT...**

**Austrian concerns:**

- Not grounded in market process theory
- Applies to both market and non-market economies
- Downplays price signals and coordination
- Doesn't explain how entrepreneurship solves coordination problems
- Focus on disruption vs. equilibration

# Ludwig von Mises: The Praxeological Foundation

## Mises' Method: PRAXEOLGY

*Praxeology = The logic of human action*

### Key principle:

- Humans act purposefully
- They act under uncertainty
- Entrepreneurship is part of every human action

### Why praxeology matters:

It's the foundation for understanding entrepreneurship in a deductive, logical system

# Mises: Economic Calculation

## **The Problem:**

How do entrepreneurs calculate costs and benefits?

## **Mises' Answer: Through PRICES**

*“Every single step of entrepreneurial activities is subject to scrutiny by monetary calculation”*

**Prospective calculation:** Planning (costs and revenues)

**Retrospective calculation:** Profit and loss accounting

**Both require market prices!**

# Israel Kirzner: The Main Event

**Publication: Competition and Entrepreneurship (1973)**

**Kirzner's Contribution:**

Synthesized Austrian insights into a comprehensive theory of **MARKET PROCESS**

**Central question:**

“How do markets coordinate dispersed knowledge and correct errors over time?”

**Answer:** Through **ENTREPRENEURIAL ALERTNESS**

# Kirzner's Core Concept: Entrepreneurial Alertness

## **ALERTNESS:**

*The ability to **NOTICE** what others have not noticed*

## **This is NOT:**

- × Superior information (everyone has same info)
- × Better calculations (a computer can do that)
- × Formal education (some alert people are uneducated)

## **This IS:**

- ✓ A way of **SEEING** the world
- ✓ Recognizing what information means

# Alertness in Action: Simple Example

## **EXAMPLE: Gasoline Arbitrage**

### **Facts:**

- Gas in City A: \$3.00/gallon
- Gas in City B: \$3.50/gallon
- Transportation cost: \$0.20/gallon
- These prices are PUBLIC INFORMATION

### **What does the alert entrepreneur notice?**

*"I can buy in A and sell in B for \$0.30 pure profit!"*

*Non-alert people see the same prices but don't notice*

# Pure Entrepreneurship

## **The entrepreneur in our example needed:**

- Capital to buy gas? NO (could use credit)
- Labor? NO (could hire it)
- Special knowledge? NO (prices are public)
- Alertness? **YES!**

## **This is PURE ENTREPRENEURSHIP:**

Profit from DISCOVERY alone  
(Kirzner's theoretical construct)

In reality, entrepreneurship usually requires capital, but the PROFIT component comes from alertness

# Discovery vs. Creation

## Fundamental Difference:

### **KIRZNER: Opportunities are DISCOVERED**

- Opportunities exist before discovery
- They were “there all along”
- Like finding money in the street
- Entrepreneur uncovers what exists

### **SCHUMPETER: Opportunities are CREATED**

- Entrepreneur creates new opportunities
- Like inventing a new product
- Entrepreneur brings into existence

**BOTH perspectives capture real phenomena!**

# Kirzner's Market Process Theory

## The Market Process:

- 1 **Disequilibrium exists**
  - Resources misallocated, opportunities unexploited
- 2 **Alert entrepreneurs notice opportunities**
- 3 **They act to exploit them**
  - Buying low, selling high, reallocating resources
- 4 **This creates PROFIT**
- 5 **Market coordinates toward equilibrium**
  - But never fully reaches it—new opportunities arise

# Kirzner's Quote on Prices and Knowledge

*“Prices were the medium by which knowledge in an economy spreads, but the **CAUSE** of that spread is entrepreneurial activity—people recognizing previously unimagined opportunities to combine inputs into more valuable outputs.”*

— Israel Kirzner (1973)

## **KEY INSIGHT:**

**Entrepreneurship is the ACTIVE FORCE that makes coordination happen**

# A More Complex Kirznerian Example

## **EXAMPLE: Healthy Fast Food Discovery**

### **Market situation:**

- Consumers want healthier fast food
- Current fast-food chains want profit margins
- Gap exists but no one is serving it
- Opportunity is “hiding in plain sight”

### **Alert entrepreneur notices:**

*“I can buy or grow ingredients, hire workers, and create a healthier fast-food experience that people WANT MORE than current options”*

**Result:** New business, employment, coordination

# Kirzner vs. Schumpeter: Reconciliation

**These views are NOT completely opposite:**

**Ordinary entrepreneurship = Mostly Kirznerian**

- Noticing gaps, inefficiencies
- Incremental improvements
- Equilibrating

**Extraordinary entrepreneurship = More Schumpeterian**

- Revolutionary change
- New products, markets
- Disequilibrating

**Most real businesses involve BOTH:**

Discovery of needs + Creative ways to meet them

# F.A. Hayek: The Knowledge Problem

## **Hayek's Question:**

“How is it possible for thousands of people to coordinate their activities without a central authority telling them what to do?”

Traditional economics says: Prices solve it

**Hayek deepens it:** Why do prices work?

Because they transmit critical knowledge:

*“The particular circumstances of time and place”*

**Most important knowledge is LOCAL, TACIT, CONTEXTUAL**

# Competition as Discovery Procedure

## Hayek's Key Insight:

### Competition is a **DISCOVERY PROCEDURE**

It doesn't allocate given knowledge efficiently  
(that's what equilibrium models say)

Instead, it **GENERATES** new knowledge that didn't exist before

### Example:

- Competition reveals what products people want
- Competition reveals what production methods work best
- Competition discovers which combinations of resources are most valuable

# Hayek and Kirzner Connect

## **Hayek provides the context for Kirzner:**

**Hayek:** Dispersed knowledge needs to be coordinated; Prices transmit information; Competition generates new knowledge

**Kirzner:** Entrepreneurship is the ACTIVE FORCE that discovers and acts on information; Alertness mobilizes dispersed knowledge

**Together:**

**Prices + Entrepreneurship = Market Coordination**

# Key Austrian Principles

## Austrian entrepreneurship theory rests on:

- 1 **SUBJECTIVISM** — Opportunities subjectively perceived, not objective facts
- 2 **UNCERTAINTY** (not just risk) — Future cannot be calculated, only imagined
- 3 **PROCESS ORIENTATION** — Focus on journey, not equilibrium destination
- 4 **PRICE SIGNALS ESSENTIAL** — Entrepreneurs need prices to calculate
- 5 **INSTITUTIONS MATTER** — Property rights, contracts, rule of law enable entrepreneurship

# Austrian View of Profit

## Pure Economic Profit comes from:

- ① **UNCERTAINTY-BEARING** (Knight) — Entrepreneur bears risk, gets rewarded
- ② **DISCOVERY** (Kirzner) — Entrepreneur notices gap, profits from alertness
- ③ **INNOVATION** (Schumpeter) — Entrepreneur creates something new, gets temporary monopoly
- ④ **BETTER ANTICIPATION** (Mises) — Entrepreneur forecasts future correctly

**NOT profit from:** exploitation, theft, or artificial monopoly

# The Harberger Triangle vs. Austrian Critique

## **Mainstream economics worries about:**

Deadweight loss from monopoly (Harberger Triangle)

## **Austrian economics says:**

“Wait—that monopoly profit might be funding the entrepreneur who will discover the next breakthrough!”

Profit → Innovation → New Products → Better Lives

**The question isn't just:** “Is the market efficient now?”

**It's:** “Does the market discover and innovate?”

# Policy Implications: Free Entry and Exit

**From Austrian theory: Remove barriers to entrepreneurial DISCOVERY**

## **Policies that help:**

- ✓ Easy business formation (minimal licensing)
- ✓ Bankruptcy is learning opportunity (not shame)
- ✓ Free capital formation
- ✓ Decentralized decision-making
- ✓ Competition as discovery procedure

## **Policies that harm:**

- × Licensing restrictions blocking entry
- × Regulations preventing trial and error
- × Central planning replacing market process

# Policy Implications: Property Rights and Calculation

**From Mises: Entrepreneurs need PRICES to calculate**

## **Requirements:**

- ✓ Private property (to create prices)
- ✓ Contract enforcement
- ✓ Clear ownership rights
- ✓ Price signals not distorted by subsidies/controls

## **Why this matters:**

Without prices, entrepreneurs cannot determine:

- What resources are truly scarce
- Where inefficiencies exist
- Whether they're making real profit

**Price distortions lead to MISALLOCATION, not coordination**

# Policy Implications: Avoid 'Pretense of Knowledge'

**Hayek's warning: "The Pretense of Knowledge"**

**Central planners and industrial policy makers believe they can:**

- Pick winners and losers
- Direct investment efficiently
- Solve coordination "problems"

**Austrian critique:**

- Coordination problems ARE opportunities
- No one can know which businesses to support
- Market discovery process better than central plan
- Pick "winners" and lose to entrepreneurs elsewhere

**Solution:** Let entrepreneurial process work

# Summary: The Austrian Perspective

**Austrian economics puts the ENTREPRENEUR at the center of economic analysis**

## **The entrepreneur:**

- Bears uncertainty (Knight)
- Creates innovations (Schumpeter)
- Calculates and forecasts (Mises)
- Discovers opportunities (Kirzner)
- Utilizes dispersed knowledge (Hayek)

## **The market process:**

- Never in equilibrium
- Tending toward coordination
- Driven by entrepreneurial discovery
- Generates growth and development

# Why This Matters Today

## **Austrian entrepreneurship theory explains:**

### **Why markets WORK:**

- Entrepreneurship discovers and coordinates
- Decentralized knowledge drives efficiency

### **Why central planning FAILS:**

- Cannot replicate entrepreneurial discovery
- Lacks dispersed knowledge
- No trial-and-error learning

### **Why INSTITUTIONS matter and FREEDOM is essential:**

- Enable or disable entrepreneurship
- Shape productive vs. unproductive enterprise
- Entrepreneurship requires freedom to try

# Key Takeaways

- 1 **Markets work through entrepreneurial discovery** (not just rational optimization)
- 2 **Alertness to opportunities drives coordination** (Kirzner's revolutionary insight)
- 3 **Profit reflects better judgment and discovery** (not exploitation)
- 4 **Institutions shape which entrepreneurship succeeds** (productive, unproductive, destructive)
- 5 **Freedom and prices are essential** (for entrepreneurial calculation)
- 6 **Discovery process never ends** (market constantly evolving)

# Further Reading

## Essential texts:

- Kirzner, Israel. *Competition and Entrepreneurship* (1973)
- Knight, Frank. *Risk, Uncertainty, and Profit* (1921)
- Schumpeter, Joseph. *The Theory of Economic Development* (1934)
- Mises, Ludwig. *Human Action* (1949)
- Hayek, F.A. “The Use of Knowledge in Society” (1945)

## Modern applications:

- Baumol, William. “Entrepreneurship: Productive, Unproductive, and Destructive” (1990)

**Start with Kirzner for clearest Austrian argument!**

# Final Thought

The Austrian approach reveals something profound:

**Entrepreneurs are not anomalies in economic theory—they ARE the theory.**

Markets work because alert, active people notice opportunities and act on them.

This is not just business—it's how human civilization coordinates millions of independent actions into a functioning, growing economic order.

**THAT is the Austrian insight.**