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Professor Hébert on Entrepreneurship

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Since I admittedly know more about Austrian economic theory than about Richard Cantillon, I would like to focus my comments on the Austrian aspects of Prof. Hebert's paper, in particular his discussion of entrepreneurship. Hebert is correct in his discussion of the differences between Mises' and Kirzner's concept of the entrepreneur and in his critique of the Kirzner approach.

Mises conceives of the entrepreneur as the uncertainty-bearer, who receives profits to the degree that he can successfully forecast the future, and suffers losses to the extent that his forecasting goes awry. One evident case of rewards in proportion to the success of forecasting is the stock or commodity markets. The stock or commodity speculator, furthermore, clearly suffers losses to the extent that his forecasting is significantly less accurate than that of his fellow speculators. But Mises points out that the market as a whole is in the same situation as the stock or commodity market. The entrepreneur who buys raw material and hires labor, and who thereby incurs costs in order to produce a future product, is expecting that he will be able to sell the product to customers for a revenue greater than the costs. Just as the stock speculator purchases stock in the hope and the expectation that it will rise in price, so the employer incurs costs in the expectation that he will be able to sell the product at a greater price.

To Kirzner, on the other hand, entrepreneurship becomes reduced to the quality of *alertness*; and uncertainty seems to have little to do with the matter. In his lectures, Kirzner likes to stress the analogy that the entrepreneur is a person who, upon seeing a $10 bill in front of his nose, is alert to the existence of the money and leaps to grab it. The alert man will grab the $10 note rapidly; the less alert will take longer to see his opportunity and to take advantage of it. One problem, as Hebert mentions, is that it is difficult to account for actual *losses*; for the worst that can happen to the non-alert sluggard is that he misses his opportunity for gaining $10. But how then does it ever come about that he actually *loses* 10 or more dollars? Moreover, by stressing alertness, Kirzner is emphasizing a quality of perception, of perceiving an opportunity that virtually exists, as a real *thing* out there. In reality, however, any profit opportunity is uncertain, and rather than be a real existing entity, it must always be subject to uncertainty. It is never as simple as mere alertness.

Take the case of perhaps the best fictional portrayal of the entrepreneurial function, Somerset Maugham's short story, *The Verger.* In this story, the illiterate verger of a church in London is fired for not being able to read or write. Walking down the street looking for a cigarette for consolation, he observes that he cannot find a tobacconist in the neighborhood, and so he decides to invest his severance pay is setting up a tobacconist shop. This comes close to the Kirzner model of "perceived opportunity," of being alert to a gap in the services provided by the market. But even here, matters were not that simple. The verger, after all, had to forecast costs and revenues, and he could well have suffered losses if his forecasting had erred greatly. The need for a tobacconist could have withered from a change of smoking habits, from a new store entering the neighborhood at the same time, or whatever.

Even Kirzner's best case, the arbitrageur, is subject to uncertainty, a point which Hebert overlooks. The arbitrageur can perceive that a product sells for one price at one place and at a higher price somewhere else, and therefore buy in the first place to sell in the second. But he'd better be cautious. The transactions are not instantaneous, and something might occur in the interim to change the seemingly certain profits into losses. It is, after all, possible that the other entrepreneurs, far from purblind to the profit opportunity lying await for arbitrage, knew something which our would-be arbitrageur does not. At any rate, he might be better advised to look before he leaps. Surely, *some* arbitrageurs in the history of the world have suffered losses.

As Hebert points out, Mises applies the concept of entrepreneur to all cases of uncertainty-bearing, and since laborers face uncertainty in deciding where to move or what occupation to go into, laborers are also entrepreneurs. But the most important case of entrepreneurship, the driving force in shaping the actual structure and patterns of production in the market economy, are the capitalist-entrepreneurs, the ones who commit and risk their capital in deciding when, what, and how much to produce. The capitalists, too, are far more subject to actual monetary losses than are the laborers.

Kirzner's entrepreneur is a curious formulation. He need not, apparently, risk anything. He is a free-floating wraith, disembodied from real objects. He does not, and need not, possess any assets. All he need have to earn profits is a faculty of alertness to profit opportunities. Since he need not risk any capital assets to meet the chancy fate of uncertainty, he *cannot* suffer any losses. But if the Kirznerian entrepreneur owns no assets, then how in the world does he earn profits? Profits, after all, are simply the other side of the coin of an increase in the value of one's capital; losses are the reflection of a loss in capital assets. The speculator who expects a stock to rise uses money to purchase that stock; a rise or fall in the price of stock will raise or lower the value of the stock assets. If the price rises, the profits are one and the same thing as the increase in capital assets. The process is more complex but similar in the purchase or hiring of factors of production, the creating of a product and then its sale on the market. In what sense can an entrepreneur *ever* make profits if he owns no capital to make profits on?

For example, I might have a brilliant idea on how to make a profit on the market. I might be keenly alert to a profit opportunity virtually lying at my feet. I may have a sure tip on the stock market. But if I haven't got any money to invest, the profits, perceived opportunity or not, will simply not be made. Entrepreneurial ideas without money are mere parlor games until the money is obtained and committed to the projects.

One Kirznerian reply to such criticisms is that the entrepreneur need not own any assets, need not be a capitalist, if he can induce other people with money to invest in his idea.

But this reply is unsatisfactory. Let us consider two possible such cases. In one example, I, with a brilliant entrepreneurial idea, sell that idea to someone with money; we invest in that project, with him putting up all the money and letting me be a junior partner because I contributed the idea. He keeps, say, 80 percent of the shares, and gives me the other 20 percent. But the Kirznerian concept is now contradicted. In the first place, the moneyed man, risking his own assets in the firm, has thereby *become* an entrepreneur. The employer who spends his capital and hopes for a profitable return *is* an entrepreneur, an uncertainty-bearer, and he is also to the same extent a capitalist, since that is the extent of assets that he is risking. But there is more to the problem than this. For I might have begun as a free-floating wraith, as a man with an idea and no assets. But because of my contract with the moneyed investor, I have now *become* a capitalist, since I now own assets to the amount of 20 percent of the firm. In other words, there are here two fundamental and fatal flaws in Kirzner's notion of the alert idea man as the entrepreneur: one, that the capitalist is *also* an entrepreneur, and two, that the pure idea man has, willy nilly, become a capitalist.

The second possible case of the entrepreneur financing his project at first blush looks more favorable for Kirzner's doctrine. The pure idea man induces a capitalist to *lend* him all the money he needs to invest in his idea. The entrepreneur takes the loaned funds and set up his business, investing in the new idea, and hoping for profits. But, once again, the Kirzner concept is contradicted. For the idea man has still become a capitalist-owner; for he now owns all the assets of the new company, even though they may be mortgaged to the hilt in loans from his backer.

The former idea man has once again, willy nilly, become an asset-owner, a capitalist. He owns the equipment and the raw material, he owns the product before sale, and he owns the money acquired from sale. He will suffer losses if the revenues do not meet expectations. It is true that he will have to share any profits with the lender by paying him interest. But the lender, though his interest return is fixed, is still partly an entrepreneur. For while his return is fixed, it is by no means certain, and if the idea fails and the firm goes bankrupt, the capitalist's money has been lost. So that he, too, still shares the entrepreneurial function with the idea man.

It might be said that, in this case at least, the idea man can lose no money because all the money was loaned to him by the capitalist. But, as in the first case where he received assets as a gift from his partner, the entrepreneur, by borrowing money, soon *became* a capitalist and asset owner. The man who borrows $1 million and then buys $1 million worth of assets is now someone risking that million, and he loses his share of the assets if he suffers insolvency. Furthermore, his interest payment is now a net loss to him. Aside from the interest due, it is true that he will not be monetarily worse off than he was at the very beginning, when he had the idea. But he will be monetarily poorer than he was while he owned the new plant. An employer-entrepreneur must be a capitalist; *at what time* he became a capitalist and asset owner is irrelevant to the theory.

If I may engage in a bit of sociology of knowledge, I think I can explain why Kirzner has deviated so sharply from the main Misesian line. In the first place, there is a certain uncharacteristic lack of clarity in Mises' discussion of entrepreneurship. While Mises basically links the capitalist and entrepreneur together in uncertainty-bearing, there are passages in his *Human Action* which treat the entrepreneur as an entirely separate entity, and not just as the forecasting aspect of the activities of the capitalist or laborer. In other words, there is a certain amount of textual justification in Mises for the Kirzner turn—justification which did not exist in Böhm-Bawerk, where the entrepreneur is clearly the capitalist and there is no possibility of such separation. On the other hand, Böhm-Bawerk did not develop the theory of profits, losses, and uncertainty to any extent, which had to wait for Mises, who grounded himself on Frank Knight as well as the other Austrians.

But, second and I think more important, Kirzner developed his theory of entrepreneurial alertness I believe in reaction to the opposite deviation from main-line Misesianism introduced into the Austrian arena by Ludwig M. Lachmann. Becoming a disciple of G. L. S. Shackle, Lachmann, and following him other younger Austrians, maintains not only that uncertainty is pervasive on the market, but also that we cannot even say that the market contains a tendency toward equilibrium, a tendency fueled by the profit-and-loss signals of the market. To Lachmann, expectations and therefore actions on the market are random, rather than responsive to market signals. It is one thing to say, with Mises and his followers, and in contrast to the neo-classical economists, that equilibrium does not and can never exist on the market. It is quite another thing to say that the market does not even harbor equilibrating tendencies.

The upshot is really the scrapping of economic theory altogether, and the Lachmannian economist becomes a mere institutionalist and historian, recording past choices and trends. There is no question that Mises would have called such a doctrine *anti*-economics. I believe that it was in horrified reaction to this Lachmannian nihilism that Professor Kirzner sought a way to downplay uncertainty and to make his entrepreneur a more tangible and objective entity earning tangible profits on the market. In the dialectic of the history of thought, it is a common occurrence for one deviation from the main line of theory to give rise to a deviation in the opposite direction. Since I believe the Mises-Hayek mainline position to be the correct one on this issue, I can only hope that these deviations will in effect cancel each other out and that Austrian thought will return to its own mainstream position.

Next, Professor Hebert mentions Schumpeter's theory of entrepreneurship, and contrasts it to the Misesian position. But while it is true that Schumpeter was trained in Böhm-Bawerk's seminar in Vienna at the same time as Mises, he early shifted to a Walrasian position. Being a Walrasian, Schumpeter had to believe that general equilibrium is a living reality, an existing state of affairs, at least part of the time. But if the world is in general equilibrium, how do business cycles or growth and development emerge?

Schumpeter's *Theory of Economic Development* was a fascinating, though ill-conceived, attempt to derive a theory of the business cycle and economic growth from a Walrasian general equilibrium starting-point. According to Walras, tastes, technology, and resources were given in general equilibrium. If we begin with the economy in that equilibrium state, therefore, any change from that state must occur in at least one of these variables. To Schumpeter, as to other neo-classical economists, tastes could not be the changing element. Tastes he regarded as basically fixed; certainly they could not be the driving force of economic change. Total supply of resources didn't change very frequently either. So Schumpeter was left with innovation in technology as the only possible motor force for any change, be it business cycles or economic development. But then Schumpeter was confronted with a problem: how would these innovations be financed? Not out of new savings, since tastes were given, and since by definition net savings are zero in equilibrium. Not out of profits, since by definition profits are zero in equilibrium. One way out might have been finance out of interest returns, since, according to Austrian theory, savings, the result of positive time preference, are positive even in equilibrium. But Schumpeter had rejected the concept of time preference, so he was left with interest and profits both being zero in equilibrium. The result was that Schumpeter had trapped himself in a Walrasian box: the only conceivable way by which new investment, which had to be in innovations, could be financed was by the creation of new money. This meant that only inflationary bank credit could finance economic development.

In short, because Schumpeter believed in the real existence of Walrasian general equilibrium, and since he boxed himself into the position that only inflationary bank credit could finance innovations, some important consequences necessarily followed. Since general equilibrium is by definition in a world of perfect knowledge and certainty, and since that world of endlessly unchanging rounds of activity has no room for entrepreneurship, it followed automatically that the only entrepreneurial function could be disruption of equilibrium. Entrepreneurs could not make any adjustments, since in the fixed and certain world of general equilibrium, there is nothing to adjust.

Secondly, it followed that entrepreneurial profits could only redound to the innovators, and that interest is the return on inflationary bank loans. Economic development, and the inflationary boom, a boom sparked by bank credit to innovations, had begun. But if the economy begins in Walrasian equilibrium, it had to return there, otherwise equilibrium is only relevant to one originating point of the economic process. Equilibrium cannot be a real entity unless a strong tendency exists to return to that state, once dislodged. So to maintain his Walrasianism in dealing with economic change, Schumpeter had to come up with the business cycle; the depression would have to be the mechanism by which the economy returned to the general equilibrium state. Schumpeter found the mechanism of that return in the alleged moment in which the new products or new equipment are finally produced and poured onto the market; the advent of the new products, Schumpeter theorized, outcompeted the older firms and drove them into bankruptcy. The losses imposed on the older firms constituted the depression phase of the cycle.

It was an ingenious schema, but with many grave flaws. Apart from the fact that there is no evidence that booms are confined to innovations or recessions to older processes (which forced Schumpeter to confuse matters still more with a multi-cycle schema two decades later), one wonders why in a Walrasian world of perfect certainty—or, indeed, in the real world of reasonably astute entrepreneurs—the older firms had to wait for the shock of the influx of new products. Why couldn't they foresee the moment much earlier and take precautionary measures?

But the major problem is fundamental and methodological. Schumpeter's business cycle theory and his theory of growth are, for all their suggestiveness, not positive theories of the real world at all; they are simply ways by which slavish adherence to Walrasian categories boxed Schumpeter in and forced him into his conclusions. In a sense, this was theory by default.*

The Schumpeter case highlights the true nature of Austrian economics and Austrian methodology. Austrian economics has generally been dismissed as extreme *a priorism*, cut off from the empirical data of the real world. The true situation is exactly the opposite. Austrian theory ruthlessly confines itself to an analysis of real life in the real world. It avoids abstract and unreal "models" and theoretical boxes. It shuns false assumptions and premises. It rests its deductive theoretical structures squarely on empirically grounded general axioms. Methodologically, it is far closer to classical economics than is the current Walrasian orthodoxy.

*For a development of this theme, see my "Breaking Out of the Walrasian Box: The cases of Schumpeter and Hansen," *Journal of Austrian Economics* (forthcoming).