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Entrepreneurial Discovery and the Law of Supply and Demand

by Israel M. Kirzner

Last month we promised to explain how Austrian economics presents its understanding of the law of supply and demand by invoking the *entrepreneurial* character of dynamically competitive markets. The key element in this Austrian understanding is the appreciation that individual buying and selling decisions are examples of what Ludwig von Mises called *human action*. For Mises, each human being is, in a very important sense, an entrepreneur. (See Ludwig von Mises, *Human Action*, 3rd edition, 1966, p. 252.) And it is the entrepreneurial element in those decisions that is responsible, in the Austrian view, for that crucially important tendency toward market-clearing that (for Austrians as well as for non-Austrians) constitutes the heart of the law of supply and demand.

The Meaning of Human Action

The Misesian notion of *human action* is significantly richer than the mainstream-economics notion of the *economizing decision*. An economizing decision is seen as the selection of the most desirable option out of *an array of given alternatives with a given ranking of what is more desirable and less desirable*. Since both the alternatives available and the ranking are already identified *prior* to the act of decision, such decision-making consists essentially of the solution to a mathematical maximization exercise; the outcome is predetermined: it is implicit in the given context within which the decision is to be made.

For Misesian human action, on the other hand, the action is, most importantly, seen as *including* the determination of both what the available alternatives are and what ranking of relative desirability is to be adopted. Determining these elements inevitably exposes the agent to the uncertainties of an open-ended future (in a sense absent in the context of the standard "economizing decision"): action is the present choice between future alternatives that must, in the face of the foggy uncertainty of the future, now be *identified* in the very act of choice. It is this aspect of human action that renders it, for Mises, essentially entrepreneurial. Mathematical expertise in solving maximization problems is of very limited help in choosing among courses of action when the very alternatives must be "created," as it were, by the agent's entrepreneurial imagination and creativity, by his daring and boldness.

The Entrepreneurial Role

For Austrian economics the entrepreneurial role is, despite—or more accurately, precisely because of—its analytical "fuzziness," responsible for the systematic character of market processes ("fuzzy" since no economist

Israel Kirzner is a professor of economics at New York University and author of The Meaning of Market Process. *This is the second in a series of articles laying out some foundational elements of modern Austrian economics.*

can "model" the creative imagination of the entrepreneur acting under open-ended uncertainty). Going beyond the context of the entrepreneurial elements in each individual human action, Austrian economics focuses on the role of the businessman-entrepreneur in the dynamic market process. The successful businessman-entrepreneur "sees" what other market participants have not yet seen; the entrepreneur sees opportunities to buy at one price and to sell at a higher price. To see such opportunities will typically call for (a) superior imagination and vision (since the perceived opportunity to sell at the higher price is likely to exist only in the future) and (b) *creativity* (since such a profit opportunity is likely to take the form of selling what one buys in an innovatively different form, and/or different place, than was relevant at the time of purchase).

It is because Mises saw each human being as, to some extent, an entrepreneur that he understood the powerful tendencies that exist in free markets for profit opportunities to be sensed and exploited (and thus eliminated) by profit-oriented entrepreneurial market participants. In a dynamically changing world, new profit opportunities are continually emerging, and their emergence continually generates the incentives toward their discovery and exploitation. It is this ceaseless re-creation and discovery of entrepreneurial opportunities that make up the market process we observe in the world around us.

The Law of Supply and Demand Reconsidered

For Austrians, the law of supply and demand is simply an insight into one particular (but central) element in this more comprehensive, dynamic, entrepreneur-driven market process. For any particular commodity, the market forces acting on the prices at which it will be bought and sold (and thus the market forces acting on the decisions made to produce and to buy it) tend to identify and exploit the opportunities (structured by the technology and the economics of its production on the one hand, and by the urgency with which potential consumers wish to consume it, on the other hand) and thus to ensure that the quantities which are simultaneously worthwhile for producers to produce and for consumers to buy will in fact tend to be produced, offered for sale, and purchased.

If, for example, current production of this commodity is "too low," this means that opportunities exist for additional units to be produced at an outlay below the highest price potential consumers would be prepared to pay; it is "worthwhile" to produce these additional units. Entrepreneurial producers will tend to discover and act on such opportunities. If, on the other hand, current production is "too high," this means that the production outlay for at least some units exceeds the highest price potential consumers are prepared to pay for them; these units were produced as a result of entrepreneurial error. Entrepreneurial producers will tend to discover these (marginal) losses and cut back on production.

The entrepreneurial forces acting on the market for any one commodity are thus continually pushing that market toward the market-clearing point—that is, to where (a) the quantity produced is such that (only) all units "worth producing" are indeed produced, and (b) the market price for this commodity is just high enough to make it, as a practical matter, worthwhile for producers to produce this quantity, and is just low enough to make it worthwhile for consumers to buy it.

Clearly, these forces would, were all other dynamic changes in market conditions to be suspended, tend to achieve exactly those outcomes identified, in more conventional mainstream formulations of the law of supply and demand, by the intersection of the supply curve and the demand curve. It is for this reason that we have described Austrian economics as basically in agreement with mainstream economics in its emphasis on the centrality of the law of supply and demand. It is worthwhile, however, briefly to ponder the sense in which the Austrian version of the "law" *avoids* reliance on any presumption of universal perfect market knowledge (a presumption that, as seen in the preceding article, pervades much standard economics).

The Role of Ignorance and Learning in the Entrepreneurial Market Process

As Austrian economist F. A. Hayek emphasized, the market process we have been describing in entrepreneurial terms can also usefully be understood in terms of *learning*. The process through which the market tends to generate the "right" quantity of a commodity, and the "right" price for it, can be seen as a series of steps during which market participants gradually tend to discover the gaps or errors in the information on which they had previously been basing their erroneous production and/or buying decisions. Buyers who had overestimated the willingness of producers to produce and sell the commodity had been "incorrectly" refusing to offer higher prices (that they would indeed have been prepared to pay); those who had underestimated that willingness were "incorrectly" offering higher prices than were in fact needed to inspire sellers to produce. Sellers who had overestimated the willingness of buyers to buy were "incorrectly" asking higher prices (and were producing more units of the commodity than it was "really worthwhile" to produce), and so on. The market process is one in which, driven by the entrepreneurial sense for grasping at pure profit opportunities (and for avoiding entrepreneurial losses), market participants, learning more accurate assessments of the attitudes of other market participants, tend toward the market-clearing price-quantity combination.

Two concluding observations are in place at this point. First, we should emphasize, once again, that this "law" is simply an element in the more general dynamic, entrepreneurial market process that is continually at work not only (as in the narrowly defined law of supply and demand) within a particular industry, but also between industries. It is this that renders understanding of the law so important for the broader and deeper understanding of the role of free markets generally in achieving socially effective economic outcomes.

Second, we should emphasize the extent to which the law of supply and demand is being continually buffeted and interrupted—and continually re-asserted and re-created—in the real world of dynamic change. (The circumstance that these dynamic changes typically take the form of forces acting on a particular commodity market from *other* commodity markets reinforces the observation made in the preceding paragraph.)

Next month we will again explore the dynamic entrepreneurial free-market process with particular concern for the nature of and role for *competition* in this process, and for the implications in regard to antitrust policy. □

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