Global Prosperity Initiative

Mercatus Policy Series

Policy Primer No. 4

The Nature and Role of Entrepreneurship in Markets: Implications for Policy

Israel M. Kirzner
Professor Emeritus, New York University

Frederic Sautet
Senior Research Fellow, Mercatus Center

June 2006

Mercatus Center
George Mason University

About Israel M. Kirzner, co-author

Israel M. Kirzner is Professor Emeritus of Economics at New York University. He received his PhD from NYU in 1957 where he studied under Ludwig von Mises. Professor Kirzner is one of the leading economists in the field of entrepreneurship and market process theory. He is the author of eleven books, including *An Essay on Capital; Competition and Entrepreneurship; The Meaning of Market Process;* and *The Driving Force of the Market*. He has authored over a hundred scholarly articles and edited five volumes.

About Frederic Sautet, series editor (with Susan Dudley) & co-author

Frederic Sautet is a Senior Research Fellow at the Mercatus Center at George Mason University. He is also a member of the Graduate Faculty at George Mason University. Prior to joining Mercatus, Frederic was a Senior Economist at the New Zealand Commerce Commission and a Senior Analyst at the New Zealand Treasury. Frederic holds a doctorate in economics from the Université de Paris Dauphine and did the course work for his doctorate at the Institut des Etudes Politiques in Paris. He also studied at New York University as a post-doc. Frederic's current work focuses on entrepreneurship, institutions, and social change.

For more information about the Mercatus Center's Global Prosperity Initiative visit us online, www.mercatus.org/globalprosperity, or contact Claire Morgan, Director of the Social Change Project, at (703) 993-4955 or cmorgan4@gmu.edu.

Cover picture: Leonardo Da Vinci - Flying Machine.

MERCATUS CENTER
GEORGE MASON UNIVERSITY

THE NATURE AND ROLE OF ENTREPRENEURSHIP IN MARKETS:
IMPLICATIONS FOR POLICY

ISRAEL M. KIRZNER AND FREDERIC SAUTET

EXECUTIVE SUMMARY

Policy makers and others often associate entrepreneurship with the creation of new businesses. While this is an accurate description of one of the many outcomes of entrepreneurial activity, entrepreneurship encompasses far more than business start-ups. It derives from the creative power of the human mind and consists of the discovery of profitable ideas that enable market actors to exploit new, socially beneficial gains from trade. As such, entrepreneurship is the driving force of the market, and it makes progress and sustained prosperity possible.

Economists emphasize that the market is a resource allocation mechanism. However, they often fail to explain *how* this allocation occurs because they fail to mention the role of entrepreneurial activity in trade. Resource allocation is the result of entrepreneurial discovery for potential gains from trade. In this sense, entrepreneurship, rather than resources and their allocations, matters more to individual wellbeing and to prosperity.

In the social context, profit drives the entrepreneurial discovery of previously overlooked opportunities for trade and thereby signals a more desirable way to organize society's resources. In order to foster socially-beneficial entrepreneurial activity, policymakers must pay attention to the quality of institutions—especially as they impact profits. Institutions that enable individuals to bet on the future and to reap the gains they have discovered will foster entrepreneurial discovery and, as a result, will create a dynamic and prosperous society. These institutions include:

- Well-defined and enforced property rights;
- Freedom of contract and its enforcement;
- Limited interference from government with market outcomes.

The Nature and Role of Entrepreneurship in Markets:

Implications for Policy

INTRODUCTION

Economic policy making presumes an understanding of economic cause and effect. This means that economic policy needs to be based on an understanding of how an economy functions, and in particular, how the market system "works." This Policy Primer demonstrates that, if we are to sharpen our understanding of *how* the market works—in order to shape economic policy appropriately—we need to focus, far more than is conventionally recognized, on the nature and role of the *entrepreneur*.

The achievements of the market system are now well-recognized in policy circles. Without centralized control and with millions of individual market participants free to make their own decisions (within the framework of law), there somehow emerges an orderly array of dynamic production activities which harnesses available economic resources in a pattern satisfying the preferences of consumers in rough accordance with *their* ranking of priorities. The economic history of the past two-and-a-half centuries has demonstrated the remarkable ability of market economies to spontaneously increase standards of living in a dramatic fashion, from hand-to-mouth subsistence to the affluence of modern living. On the other hand, economies which have limited the scope of market freedom have systematically lagged in economic growth. Adam Smith famously spoke of the "invisible hand." Friedrich A. Hayek once described the market as something of a marvel. However, in order for this acknowledgement to be useful for policy, we need to understand *how* the counterintuitive results of the market system are, in fact, able to come about.

As it turns out, entrepreneurship plays a crucial role in the market process. Policy makers and others often associate entrepreneurship with the creation of new businesses. While this is an accurate description of one of the many outcomes of entrepreneurial activity, entrepreneurship encompasses far more than business start-ups. This crucial insight has deep policy implications. To be sure, economic policy formulated without an understanding of the role entrepreneurs play, we shall argue, is likely to be deeply flawed and, indeed, an obstacle to economic progress and prosperity. In light of this, good economic policy objectives consist in establishing the institutional conditions that enable entrepreneurship (i.e., enforcing property rights and respecting the freedom of contract and the free entry in markets) and not in trying to support it directly and actively.[1]

[1] This Policy Primer is not concerned with applications of the concept of entrepreneurship to areas such as "social entrepreneurship" or "institutional entrepreneurship."

This Policy Primer explains the role entrepreneurship plays in markets and provides general recommendations for policy makers. The fundamental, policy-relevant ideas in this primer are twofold:

- Entrepreneurship is not a resource; it is the generation of socially-productive ideas which makes the use of resources possible. It is this generation of ideas and not the existence of resources that matters most to prosperity.

- The entrepreneurial discovery process drives resource allocation. In essence, resources are allocated as a result of entrepreneurial activity. Policies can affect this process in different ways. The peril of regulation comes, not only because it disrupts the patterns of consumption and savings, but also, and primarily, because it stifles entrepreneurial discovery.

At a time when "innovation" and "knowledge" are key words for policy makers, understanding the process that leads to the making of socially-productive ideas is a precondition to prosperity.

This Policy Primer is organized as follows. We first explain the meaning of entrepreneurship by providing a few examples. We then distinguish entrepreneurial discovery from other related activities. Next, we present characteristics associated with entrepreneurs. We consolidate all this knowledge in the following section, explaining the role of entrepreneurial activity in markets by focusing on resources and competition. In the last part of this primer, we consider the moral aspect of profit discovery and provide policy implications.

A. The Economics of Entrepreneurship

A.1 The Meaning of Entrepreneurship

The concept of entrepreneurship is a notoriously difficult one to pin down, which is why economists and policy makers alike have so often entirely overlooked it or gravely misunderstood it. An artificial non-market scenario can help us identify its meaning. We deliberately choose an imagined Robinson Crusoe context (although this primer is primarily concerned with entrepreneurship in *market* processes) because we wish to avoid common *mis*understanding of what entrepreneurship in fact means *in markets*.

Let us imagine that Crusoe has, while exploring his island one morning, accidentally slid into a fairly deep, wide hole in the ground. Although he is, fortunately, uninjured, he finds himself unable to climb out of the pit. Each attempt he makes to climb out causes him to slip back to the bottom of the hole. Crusoe ponders his plight and has what may be a bright idea. He has noticed that there are a considerable number of substantial-sized tree branches at the bottom of the hole. Crusoe examines these tree branches and realizes that, by carefully arranging a number of them in an ascending array, he just might be able to use them as means of ascent. Implementing this plan takes

a good deal of hard work and he is, up until his last gingerly-taken step up his precarious ladder, not at all sure that his plan will in fact enable him to escape from his "prison." After all, building this ladder and attempting to climb it may perhaps result in his falling back into the hole (with possible serious injuries).

Let us imagine, however, that Crusoe's plan works successfully. Crusoe has escaped from his hole by constructing ("producing") a primitive, crude "ladder." To achieve this he has deployed available resources (the tree branches he found at the bottom of the hole as well as his own time and energy). When, in later years, he looks back at his escape, he may be tempted to ascribe it *entirely* to the resources used in constructing the ladder. Without these resources he could not have had his ladder. Nothing more than these resources was, it may appear, needed in order to produce the ladder. Yet a moment's reflection should convince us that in fact, in a deeper sense, his escape, and the ladder which made that escape possible, can be attributed *entirely*, not to those resources, but rather *to the "good idea" which Crusoe had—to try to build his ladder*. Without this good idea, nothing would have happened; without this good idea, the tree branches and Crusoe's time and energy would not have been seen as resources at all. It was through this good idea that Crusoe's attention was drawn to the escape potential contained in those tree branches and in his own lifting capacities. It is this "good idea"—responsible for the entire escape project—which represents the *entrepreneurial* element in the "production" of Crusoe's escape.

It is worth noting that our Crusoe scenario is one in which *alertness* to possible gain has inspired the "*discovery*" of a *pure profit* possibility. Crusoe certainly sees his escape from the hole as worth much more than the effort he expended in deploying those branches in constructing the ladder! His idea was a "profitable" one. (On the other hand, however, this alertness might have resulted in a "loss." Crusoe could have injured himself in the course of his activities, while failing to make his escape.) What inspired Crusoe's good idea was his overpowering desire to escape from his near-disastrous predicament. This overpowering desire to escape did not *produce* Crusoe's good idea; rather, as we have argued, it *inspired* that idea.

A.2 Entrepreneurship in the Market

When entrepreneurship is manifested in markets, a profitable idea takes the form of someone noticing that "resources" can be acquired for a certain sum of money and converted into a "product" able to be sold for a greater sum of money. This alert "noticing" may consist of perceiving a price differential for the same item in two markets (in which case, of course, the "resource" and the "product" are one and the same). This is the basis for the pure arbitrage model of entrepreneurship. In most cases the alert "noticing" consists (in addition to becoming aware of relevant price differentials) of alertly noticing how physical resources can be assembled to generate (physically different) products—for example by the invention of a new technique, in an innovative, profitable manner.

No process of physical production in the market

> *"No process of physical production in the market economy occurs without someone first having noticed its possibility. All (profitable) production results from (good) ideas, inspired by the drive to grasp profit opportunities."*

economy occurs without someone first having noticed its possibility. All (profitable) production results from (good) ideas, inspired by the drive to grasp profit opportunities. This element of entrepreneurship is itself *not* a resource (in the sense in which land, lumber, steel, labor, and machinery are resources). Land, lumber, steel and the rest, are resources in the sense that they are *deliberately deployed* in the course of processes of production. Someone wishing to build a house must assemble land, labor, steel, lumber, and so on, in order to build the house. He must acquire land and use these resources.

However, the idea that building the house would be a profitable venture is not *deployed*. One does not initiate a productive venture by first going into the market to *acquire* a good idea. One *has* the good idea that it would be profitable to acquire resources in the market for specific production processes. One does not deliberately *produce* entrepreneurial ideas; one serendipitously *discovers* them. The circumstance that production processes typically require is the deliberate assembly of the requisite information and knowledge, making it necessary to distinguish carefully between the deliberate acquisition of useful knowledge and the discovery of good (i.e., profitable, entrepreneurial) ideas. Let us consider more carefully what it means to search deliberately for (i.e., to *produce*) information.

A.3 Search, Knowledge, and Entrepreneurial Discovery

A great deal of production activity consists in the production of knowledge and information. Newspaper reporters scour our cities to gain knowledge of events as they occur. Scientists, pure and applied, search for new scientific or engineering knowledge. Prospective authors comb the great libraries of the world to extract little-known nuggets of information, or to reveal hitherto unknown facts, in countless areas of research. The search for knowledge may be undertaken as a labor of love, fueled by no further motive than the pursuit of truth. It may also be a *profitable* endeavor, in which the market value of the knowledge produced exceeds the costs of search.

It is important for the sake of understanding the nature of entrepreneurship and for its policy consequences to distinguish sharply between the deliberately undertaken search for knowledge on the one hand, and the entrepreneurial "hunch" or "vision" *that such a search will be worthwhile*, on the other. The profitability of a research endeavor is no different than the profitability of opening a successful new retail store. Both profitable undertakings are to be attributed to the entrepreneurs'

having had "good ideas." The retailer realized that a new store at a particular location could be a lucrative endeavor; the researcher (or his employer) realized that valuable new knowledge can be obtained at a relatively low research cost.

Producing this knowledge through systematic research is *itself* no more entrepreneurial than renting the new retail location, stocking its shelves, and hiring its employees. What is entrepreneurial in both cases is the "good idea," the *discovery* of a profit possibility, whether in the opening of a new store or in the generation of new, valuable information. Research may be *un*profitable. Just as opening a new store in the wrong location can generate losses, so too may research result in new knowledge which possesses no significant commercial value.

The successful entrepreneur in the production of knowledge is the one who has been alert to the potential of hiring particular scientists, engineers, or other researchers, to generate the knowledge needed to produce valuable new products or new techniques. Knowledge as deliberately produced output is *not* entrepreneurial discovery; rather, entrepreneurial discovery is the alert awareness of the profit potential of such producible knowledge.[2]

A.4 The Meaning of Pure Entrepreneurial Profit

Pure entrepreneurial profit is won by realizing that there exists a difference between the prices of the same items in different markets (a difference greater than the costs of relevant transportation and the like). This is the case no matter what separates these different markets: a short physical distance, thousands of miles, or simply, in the case of pure speculative profit, the passage of time. The entrepreneur buys in one market at a lower price and sells in a second market at a higher price.[3] What he sells in the second market may, as noted above, be the very same physical item that he has bought (as in entrepreneurship resulting in international trade), or it may be a product which is physically entirely different from the resources (purchased in the first market) out of which the product has been produced.

This latter case exemplifies the entrepreneurship that has discovered profit in the production of a totally new product or a totally new way of producing an already well-known product (such as in the innovation of a new technology). It may also exemplify entrepreneurship that had discovered new low-cost sources of resource availability (for the conventional production of a known prod-

[2] Some authors argue that the effects of entrepreneurship in markets are limited because of externality problems. See for instance Ricardo Hausmann and Dani Rodrick (2003) "Economic Development as Self-Discovery" *Journal of Development Economics*, 72(2): 603-33. These views do not make the crucial distinction between the deliberately undertaken search for knowledge on the one hand and entrepreneurial discovery on the other. In these approaches, the entrepreneur is not a discoverer but rather a pure risk-taker in a world of already-identified profit opportunities.

[3] Ludwig von Mises (1962) "Profit and Loss," in *Planning for Freedom and Other Essays and Addresses*, 2d edition, South Holland, Ill.: Libertarian Press, 109.

uct), or entrepreneurship that has discovered markets in which a known product is needed with hitherto unknown urgency (so that consumers there are prepared to pay the higher prices).

What is entrepreneurial in all these situations is the element of *discovery*—someone has alertly noticed a relevant price differential. He has had what he believes to be a profitable idea.

At one level, pure profit is (as we have seen) simply the difference between the product's selling price and the sum of all relevant resource prices. At a deeper level we can recognize that the economic reality, which pure profit reflects, is the difference between a *low*-valued deployment of those resources (expressed in the lower prices at which the resources were able to be bought) and the *more* valuable use to which the entrepreneur has diverted these resources (as evidenced by the higher selling price, which his customers have been prepared to pay for the product which he has produced).

Pure profit reflects the existence of a value gap between what is currently supplied in the market and what the entrepreneur discovered. By discovering more valuable resource use, entrepreneurship creates value and thus participates in improving the consumers' wellbeing and quality of life.

A.5 Alertness, Innovativeness, and Boldness

Our discussion of entrepreneurship has focused on alertness and discovery as its essential elements.[4] In the literature of entrepreneurial theory, other characteristics of entrepreneurship have sometimes been emphasized.[5] It may be useful to point out two important elements singled out in the literature (and to relate them to the entrepreneurial discovery which we have identified as the root entrepreneurial element).

Joseph A. Schumpeter saw *innovativeness* as the essence of entrepreneurship.[6] For Schumpeter the entrepreneur is the one who introduces the new product or the new technique. Inventions and innovations are the key elements in Schumpeterian entrepreneurship. Pure entrepreneurial profit is created by generating something new.

Other writers, taking their cue from Frank H.

[4] For the further development of this theme, see Israel M. Kirzner (1973) *Competition and Entrepreneurship*, Chicago: University of Chicago Press.

[5] For a survey of alternative theories of entrepreneurship, see Robert F. Hébert and Albert N. Link (1988) *The Entrepreneur: Mainstream Views and Radical Critiques*, 2d edition, New York: Prager. For an explanation for the exclusion of the entrepreneur from textbook microeconomics, see William Baumol (2005) "Entrepreneurship and Invention: Towards their Microeconomic Value Theory," AEI-Brookings, http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1235.

[6] Classic statements of Schumpeter's position were presented, *inter alia*, in his 1912 book, translated into English and published as Joseph A. Schumpeter (1934) *The Theory of Economic Development*, Cambridge: Harvard University Press; and in Joseph A. Schumpeter (1942) *Capitalism, Socialism and Democracy*, New York: Harper and Row.

Knight,[7] have seen the essence of entrepreneurship in the radical uncertainty which envelops entrepreneurial activity. Such activity invariably involves speculation regarding the open-ended future. This future confronts the would-be entrepreneur with absolutely inscrutable uncertainties, against which actuarial skills are completely irrelevant and powerless. Whereas we can, at least in pure theory, imagine an owner of a resource (say a day laborer who possesses raw labor power) selling his resource services for a definite price (i.e., at a market-determined given wage rate) without subjecting himself to any uncertainties—his employer (who pays the wage hoping to use the labor he hires to produce a product which he can sell at a profit) faces a future in which *nothing* is certain. *Any*thing could go awry in the process of production: consumer preferences may change, rendering his product unneeded; other entrepreneurs may be innovating techniques which may enable them to produce and sell the same product at drastically lower prices, and so on.

To buy and sell in different markets is to engage in activity the results of which are, unavoidably, absolutely uncertain. It is the *boldness* of the entrepreneur in grappling with absolute uncertainty, which in fact makes possible the innovations and the pure profits which we generally associate with entrepreneurship. If the future were certain, there would be no entrepreneurship. Without boldness and determination, one only shrinks back from undertaking entrepreneurial ventures.

The discovery and exploitation of a profit opportunity in the face of an uncertain future therefore entails a dose of "speculation." When an entrepreneur has speculated successfully in an uncertain market, his success can be attributed to his correct realization (earlier than that of other speculators), or his correct "discovery," of the prospective price differential which constitutes his profit. Discovery, made in regard to the open-ended future of an uncertain world, is always speculation.

We should emphasize that *all* of these elements (innovativeness, uncertainty, boldness, and speculation) in entrepreneurship are important. In the real world (as distinct from the world of pure theoretical models), *all* these characteristics of entrepreneurship are likely to occur together and inseparably. The profits won in innovative (Schumpeterian) entrepreneurial activity can be traced to the alert discoveries made by the innovative entrepreneur and to the boldness and determination with which the entrepreneur pursued his "hunch" in the face of uncertainty.

Real-world entrepreneurs (if they are to be successful) must be far-sighted (i.e., alert to recent and prospective changes), bold and self-confident (in order to act in the teeth of radical uncertainty), and innovative (i.e., prepared to recognize the need to

[7] Knight's theory was published in 1921 in his celebrated *Risk, Uncertainty and Profit*, Boston and New York: Houghton Mifflin.

change as well as the possibilities for change).[8] In this primer we have chosen to emphasize the *alertness*, which is the foundation of entrepreneurial discovery, only because we believe that such emphasis can help us clarify a number of aspects of the entrepreneurial role in modern markets, especially in the context of the shrinking global economy.

A.6 How Markets Work: The Role of Entrepreneurship

Economic science has taught us that markets do work. For instance, in the case of "simple" markets, freely flexible price movements encourage buyers and sellers to discover each other's readiness to sell or to buy. That is, as elementary economics teaches us, the market price of a given good, be it input or output, tends to move towards the level which (in the limit) *brings together all buyers and sellers willing* (respectively) to buy at that price (or, at an even higher price, if necessary) and to sell at that price (or at an even lower price, if necessary). A market for apples or fish, on any given day, tends to generate a price such that (in the limit) only those potential sellers unwilling to sell for a price as low as this market-generated price and only those potential buyers unwilling to pay a price as high as that price fail to participate in exchange activity. The market process has often been described as *a decentralized social instrument for mutual discovery*.[9]

Markets communicate information

In such simple markets as these, as well as in much more "sophisticated" markets (e.g., futures markets), *competitive entrepreneurship drives this discovery process*.[10] Someone who believes he can buy a case of apples for ten dollars and resell them for twelve (including transportation and capital costs) has had, he believes, a profitable idea. This profitable idea, when implemented in the market, tends to communicate to those selling for ten an awareness of the existence of consumers who are willing to pay twelve. Similarly, this profitable idea tends to communicate to potential consumers willing to pay twelve that there exist potential sellers eager to offer them apples for less than twelve.

[8] In his book, *The Origin and Evolution of New Businesses* (published in 2000 by Oxford University Press), Amar Bhidé describes some characteristics he has observed in cases of individuals starting new businesses. One such quality is a tolerance for ambiguity, which is another way of describing the self-confidence needed to act amidst uncertainty.

[9] A seminal paper that pioneered this way of seeing the market process was F. A. Hayek (1945) "The Use of Knowledge in Society," *American Economic Review*; reprinted in F. A. Hayek (1949) *Individualism and Economic Order*, London: Routledge and Kegan Paul. On the issue of the market as a decentralized process and in opposition to the theory of central planning, see Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth" in F. A. Hayek, ed., (1935) *Collectivist Economic Planning*, London: Routledge and Sons.

[10] For a more detailed account of how competitive entrepreneurship enables markets to work, see Israel M. Kirzner (1997) *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, IEA Hobart paper, No. 133, London: The Institute of Economic Affairs. See also Israel M. Kirzner (1997) "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach" *Journal of Economic Literature*, vol. XXXV, March, 60-85.

As long as there exists a significant differential between the prices for apples in two markets, there exists a situation in which (a) communication has, up until now, been less than perfect (i.e., some are paying twelve dollars for an item available for ten; some are selling for ten dollars an item for which some consumers are in fact paying twelve), and (b) there exists the scope for the discovery of a pure profit opportunity (i.e., for someone to buy at ten and sell at twelve). It is the lure of gain which inspires the *discovery* of such pure profit opportunities, and it is in the grasping and implementation of such discovered profit opportunities that the market performs its function of communication.

Entrepreneurship may take place in small and large organizations alike

We saw earlier that all production activity involves entrepreneurial discovery. No matter how sophisticated and how complicated an industrial process may be, it is driven by entrepreneurial discovery of price differentials (i.e., of pure profit opportunities).

To be sure, profit opportunities in more complex situations than the market for apples are also more complex. They involve price differentials separating the sum of prices of a complex resource bundle from the price at which it is hoped to sell the output which that bundle can generate.

> *"What inspires entrepreneurs in market economies to take advantage of available resources in order to satisfy the consumers is the circumstance that every as-yet-unexploited opportunity for improving the pattern of production expresses itself in the form of an opportunity for pure profit waiting for entrepreneurial discovery."*

Entrepreneurship in markets is by no means confined to *individual* entrepreneurship or to the initiation and the running of small businesses. Entrepreneurship is also exercised in large, complex business organizations of a national or even of global scale.[11]

Entrepreneurial discovery matters more than resources

The profit principle—even where it manifests itself in the most complex of situations—is the very same principle that operates in the simplest of markets. What inspires entrepreneurs in market economies to take advantage of available resources in order to satisfy the consumers is *the circumstance that every as-yet-unexploited*

[11] For an analysis of the important role played by entrepreneurship in the large business organization, see Frederic E. Sautet (2000) *An Entrepreneurial Theory of the Firm*, London and New York: Routledge. Note that the organizational arrangements (such as the multidivisional firm) set up to exploit discovered opportunities are themselves the result of entrepreneurial discoveries.

opportunity for improving the pattern of production expresses itself in the form of an opportunity for pure profit waiting for entrepreneurial discovery. Markets "work" because the discovery of good entrepreneurial ideas constitutes the discovery of ways of improving the efficiency of production with given resources, the discovery of sources of as-yet-untapped resources, and the discovery of as-yet-unknown possibilities for consumer satisfaction.[12]

What needs to be emphasized again and again is that entrepreneurial discovery is, in a profound sense, more crucial to the functioning of markets than are resources, no matter how important these may be. A public policy (or natural disaster) that results in a shrinking of energy sources (or raw materials such as rubber or steel) means that the market economy will have to do with less. The market process will have to rearrange prices, patterns of production, and structures of financial arrangements in order to cope with the tightened supply conditions. But a public policy that somehow prevents entrepreneurial discovery from happening does not confront the market with a resource shortage. *Such public policy tends to stifle the market process altogether*.

Market activity depends upon entrepreneurship but *not* in the sense that the automobile industry depends upon the availability of steel or in the sense in which Crusoe's escape depended upon the availability of tree branches at the bottom of the hole. Market activity (and thus economic development) depends upon entrepreneurship in the sense that Crusoe's escape depended on his capacity to have "good ideas." Without good ideas, Crusoe would remain at the bottom of his hole. Without the possibility of good ideas being discovered—and subsequently implemented—markets could not "work" at all.

A.7 Competition and Entrepreneurship

Public policy towards the fostering of entrepreneurial discovery calls for the recognition of a most important (yet widely overlooked) circumstance: entrepreneurship and market competition are two sides of the same coin.[13] The meaning of market *competition* is often seriously misunderstood.

For present purposes it is sufficient to note that in the broadest sense of the word, competition means *absence of privilege*. Absence of privilege in the market context in turn means *complete free-*

[12] The importance of entrepreneurship illustrates the fact that many prosperous nations have little in the way of natural resources, while many resource-rich countries remain income-poor. For more on growth and entrepreneurship, see Israel M. Kirzner, "The Entrepreneurial Process," reprinted in Israel M. Kirzner (1985) *Discovery and the Capitalist Process*, Chicago: University of Chicago Press. For a different approach that understands entrepreneurship in a behavioral sense (i.e., exploiting an opportunity and starting a business), see for instance, Zoltan Acs (2006) "How is Entrepreneurship Good for Economic Growth?" *Innovations*, 1(1), 97-107.

[13] This theme was pursued extensively in Kirzner, *Competition and Entrepreneurship*, op. cit.

dom of entry. A competitive economy is one in which (within the proper institutional framework, as explained below) no arbitrary obstacles to competitive entry are imposed by governments or any other extra-market party. Absence of privilege means that no potential entrepreneur is prevented from exploiting a discovered profit opportunity because of a protectionist limit against imports or because incumbent firms have, through political pressure, succeeded in blocking entry (such as often exemplified in licensing requirements or in "anti-trust" obstacles against the merger of firms into more effective production units). *Obstacles against entry constitute obstacles to entrepreneurial discovery*.

Similarly the possibility of entrepreneurial discovery constitutes the most powerful inspiration for competitive entry. A large firm may conceivably acquire monopoly power through acquisition of sole control over an important resource. But no one, and no firm, can conceivably acquire sole control over "alertness," that is, over the capacity to have "good" (i.e., entrepreneurial) ideas.

In a competitive economy a potential new entrant who believes he has a good idea (e.g., an idea of how to assemble resources—possibly through the expenditure of borrowed capital—to produce a product able to be sold at a profit) is free to attempt to implement that idea. In so doing he is competing with other producers both in gaining command over resources (since he must outbid others who might have used those resources) and in the sale of products to consumers (who must be attracted away from spending their consumer dollars on the products of other producers). When our new entrant successfully carries out his new, profitable idea, he wins profits only up until the time when some other entrant has an even better idea (*viz.*, one which persuades resource owners to sell their services to *him* and/or consumers to spend their consumer dollars on *his* products). The competitive process consists of nothing else but a series of competitive discoveries. Contrary to mainstream economic theory, competition is not a state of affairs, but a rivalrous discovery process. The drive to generate new entrepreneurial ideas *is* the competitive process.

A.8 Entrepreneurial Activity and Consumer Well-Being

Because they overlook or misunderstand the meaning and the role of entrepreneurship, critics of the market economy have often come to believe that the uncurbed drive to win pure entrepreneurial profits tends to be harmful to the consuming public and to working employees. After all, were resource incomes (such as wages) to have been higher and/or consumer goods prices to have been lower, only the entrepreneur would have been the worse off. Both workers and consumers would have gained at the expense of the entrepreneur. The truth is, however, quite the reverse. Successful entrepreneurship, i.e., the implementing of profitable ideas, tends systematically to identify and correct inefficiencies and waste in the pattern in which society's scarce resources have hitherto been deployed. Sometimes a superficial examination of the facts

may obscure the beneficial effects of entrepreneurial success. It will be helpful to show the fallacies involved in such superficiality.

Take an industry (like the horse-carriage industry in the late nineteen century) which had attained a fairly even and stable level of service to the consuming public (and a fairly even and stable pattern of income-provision to workers, investors, and raw material suppliers to the industry). Imagine now that a brash, innovative entrepreneur enters the market, say, by producing automobiles. He has discovered that existing technology, existing engineering skills, and existing pools of resource supply, can, for a relatively low total cost, be deployed profitably to produce a vehicle that consumers strongly prefer over the horse-carriage.

As more and more entrepreneurs discover the profitability of this new line of production, the old horse-carriage industry, with its intricate webs of established industrial relationships, becomes catastrophically disrupted. Workers in the old industry are thrown out of work and the capital invested in the old industry fails to generate profit. In fact the capital equipment used in the carriage industry loses most of its economic value, generating severe losses to the owners. Traditional suppliers to the horse-carriage industry find themselves without their long-time customers. Surely it is the drive for entrepreneurial profit that has caused all this economic chaos, misery, and distress? No doubt there is a sense in which this might be indeed true, yet this scenario can easily be misinterpreted. In fact this scenario illustrates the *benefits* (rather than the damage) that results from innovative entrepreneurship.

The truth is that our hypothesized horse-carriage industry, prosperous though it may have been for its participants, was, it has now become revealed, *misusing* society's scarce resources. These scarce resources that *might* have produced automobiles (which we now know to have been potentially *more* valuable to the consuming public) were being misused to produce items of lower value to consumers. In disrupting the old horse-carriage industry, the brash automobile entrepreneur may indeed have caused economic distress to incumbent carriage producers. However, this distress merely reflects the groundless earlier expectations (of the horse-carriage manufacturers) that they could indefinitely continue to live comfortably by misusing society's resources. (Of course, when we describe them as "misusing" society's resources, we do so only with the benefit of the hindsight granted to us as a result of the discoveries made—under the conditions of highly uncertain speculation—by the automobile entrepreneurs). We may commiserate with and deplore such economic distress, but we should recognize that the new competition has merely revealed the falsity (as well as the harmfulness to the public) of these earlier expectations.

A.9 Entrepreneurship, the Morality of Profit, and the Incentives for Discovery

Before turning directly to the implications of our insights concerning entrepreneurship for economic policy, we should perhaps pause to clarify one frequently misunderstood aspect of entrepre-

neurship. This relates to the *morality* of winning pure entrepreneurial profit. One often comes across attacks on the market system that are rooted in the conviction that winning entrepreneurial profits is inherently immoral, expressing greed and deceitfulness, and constituting outright violation of simple economic justice. Time and again this view is offered without reasoned argumentation. It is held to be obvious that if an entrepreneur sells to consumers for a price of $25 that which he produced at a cost of $10, he must have illegitimately overcharged his customers, underpaid his suppliers and laborers, or both.

This is not the place for a detailed exposition of the logical fallacies underlying such criticisms,[14] but we should briefly point out that the $15 pure profit captured by the entrepreneur was taken from no one. It was the entrepreneur who discovered that what he produced at a cost of $10 could be sold for $25. No one else had been aware of the possibility of selling these services (or the product of these services) for $25.

For everyone else in the market, *there simply was* no possibility of gaining more than $10 by selling what the entrepreneur discovered he could produce. Our entrepreneur is the only one whose estimation of the future state of the market has led him to believe that, despite the utter uncertainty of the situation, there is a good chance of making pure profit through the deployment of the resources which he buys. Neither any other potential producer in the market nor any potential buyer of the entrepreneur's final product has seen what our entrepreneur *has* seen. The entrepreneur has discovered and created $15 of value by allocating some resources to a higher-valued use.

Most people do believe in the moral force of a right of the discoverer to appropriate what he finds. Indeed, if one subscribes to any form of "finders-keepers" ethic, matters must appear quite differently than they do to the critics of entrepreneurial profit. It must, indeed, be seen that the entrepreneur has *discovered* his pure profit opportunity; in a very significant sense he has *created* that pure profit opportunity. It would be *immoral* to confiscate away the result of one's creation.[15]

[14] For further development of ideas in this section, see Israel M Kirzner, "The Nature of Profits: Some Economic Insights and Their Ethical Implications," in Robin Cowan and Mario J. Rizzo, eds., (1995) *Profits and Morality*, Chicago: University of Chicago Press.

[15] Now, *if* one seriously believes that the first discoverer of gold in a given area or of oil in a given area has a moral obligation to share his discovery with the rest of mankind—then the critics of the morality of winning pure profit have a point. The entrepreneur, according to this belief, is not entitled to own that which he found. But surely most people do *not* share this moral conviction. Also, some critics of the justice of winning pure profit argue that pure profit results from pure luck. Since the lucky winner did not "deserve" his luck (by definition of luck), it is unfair to others that he be its sole beneficiary. But this misunderstands the source of pure entrepreneurial profit. While luck certainly plays a role in all human affairs, it would be a serious mistake to ascribe profit, as such, to luck. For a discussion of this issue, see Israel M. Kirzner (2000) *The Driving Force of the Market, Essays in Austrian Economics*, London and New York: Routledge, 99f.

The other important reason why a finder-keeper rule matters to entrepreneurship is the fact that profit confiscation must render it unlikely that future potential entrepreneurs will indeed ever *notice* future opportunities for better use of society's resources. The lure of profit is the incentive for entrepreneurial discovery. In the market, entrepreneurs are guided by the existence of profit towards socially-beneficial endeavors. Confiscating entrepreneurial profit (or part thereof) reduces the likelihood of entrepreneurial discovery.

B. Implications for policy and institutional change

Entrepreneurship as presented and explained above relates to the creative power of the human mind, which, in the social context, can lead to the discovery of gains from trade in most aspects of life. The points made above all lead to specific policy implications. The overarching message of this primer is that entrepreneurs will tend to discover hitherto overlooked socially-beneficial opportunities for profit only under certain institutional and policy conditions. As far as entrepreneurship is concerned, the institutional and policy objectives should be to establish the best conditions possible enabling individuals to bet on the future with the goal of creating more value than what was used up in the production process (after taking into account the opportunity cost of capital).

Let us now consider the policy implications stemming from the analysis in the first part of this Policy Primer.[16]

B.1 Do not try to support entrepreneurship directly

As the Crusoe example illustrates, entrepreneurship is always present. It is a distinguishing aspect of human nature to be capable of creating new ideas. The power of the creative mind is at work everywhere and all the time—in the personal context as well as in the broader social context. Through the work of innovators and scientists, entrepreneurship is the source of technological advancement in society. It is also the source of organizational change when individuals find new ways to organize their activities, and it is further the source of human capital accumulation when individuals realize the value of education with regard to the goals they want to achieve.

In the social context, entrepreneurship often entails starting a new business. However, in many instances, it does not have much to do with business start-ups. Entrepreneurship takes place within established firms as they grow in size and scope.

[16] For a more complete approach to the policy implications of entrepreneurship, see the following works by Kirzner: "The Perils of Regulation," reprinted in *Discovery and the Capitalist Process*, op. cit.; "Taxes and Discovery: An Entrepreneurial Perspective," reprinted in *Discovery and the Capitalist Process*, op. cit.; and "Competition, Regulation, and the Market Process: An Austrian Perspective" (1982) *Cato Policy Analysis* No. 18, http://www.cato.org/pubs/pas/pa018.html. See also Frederic Sautet (2002) "Kirznerian Economics: Some Policy Implications and Issues," *Journal des Economistes et des Etudes Humaines*, 12(1), 131-151.

It also takes place within the context of the family and other types of organization. Whether entrepreneurship is exercised and how it is exercised depends on the institutional conditions for its emergence. In other words, the institutional context influences the existence, magnitude, and nature of opportunities for entrepreneurship.

The distinction made in the first part of this primer—between the deliberate production of knowledge and the discovery of new knowledge—is crucial to policy making. All production rests on an initial idea; this is also true of the production of knowledge. It follows that policies supporting the production of knowledge may fuel the deliberate production of knowledge rather than the discovery of new information. Policies promoting research and development (R&D) within firms, for instance, by overlooking the mechanisms by which profit opportunities are discovered and exploited, may be fueling the deliberate production of information instead of the growth of new knowledge.

Consequently, policies focusing on business start-ups, promoting R&D, or strengthening business clusters may miss the point. If policy makers wish to foster entrepreneurship, they should focus on the *conditions* that enable the generation of socially-productive ideas, *not* on the number of new business start-ups. Any measure of the number of new start-ups in an economy is necessarily incomplete as a measure of entrepreneurship. Moreover, the generation of new ideas is notoriously difficult to measure.[17]

B2. Limit interferences with the profit and loss mechanism

As explained in the first part of this primer, pure profit is the difference between a low-valued deployment of resources and a more valuable use to which the entrepreneur has diverted these resources. Pure profit plays a very important role, as (a) it creates the incentives for entrepreneurial discovery and (b) it provides a feedback mechanism helping individuals assess the quality of their decisions—entrepreneurs sometimes make mistakes in their judgment of the future conditions of the market, which is also why the profit and loss mechanism is important. It is crucial for society to have access to the knowledge provided by pure profit. In its absence, individuals have no way of knowing how resources should be reallocated to satisfy more urgent needs.

In essence, the allocative properties of the market are the result of profit-driven entrepreneurial activity. Policy makers cannot rely on market

[17] The *Global Entrepreneurship Monitor* provides an extensive data base of business start-ups measures for many countries, http://www.gemconsortium.org/. In addition to the idea that entrepreneurship encompasses more than starting up a business, another issue with business start ups is that they may be instances of "superfluous discovery" (i.e., regulation-induced discoveries, which may be socially unproductive).

mechanisms in the absence of pure profit. The promotion of successful entrepreneurship entails the existence of policies enabling individuals to be alert to noticing new opportunities for gains from trade. This can only take place if pure profits can be discovered and seized.

In practice, many regulations and policies may have a negative impact on the existence of pure profits. Taxation is a major government policy which may reduce pure profits. Other direct interventions in the market place, such as rent control, may have harmful effects, which will stifle the discovery process.

B.3 Maintain the high responsiveness of the market system

The entrepreneurial discovery process is not instantaneous. Markets communicate information—this information has to be noticed and this process is not automatic. In this regard, an inefficient (from the point of view of an omniscient being) allocation of resources can remain for a long period of time until someone notices that a more desirable way of organizing production and exchange can be introduced.

Entrepreneurs have a strong interest in discovering unsatisfying situations because of the profit incentive. Entrepreneurs can discover where failures of coordination exist and take action to correct them. In essence, the competitive entrepreneurial process will tend to discover over time unsatisfying situations and replace them with more desired ones.

> *"When erecting barriers to the capture of profit opportunities, policy makers should realize that they weaken the quality of the economic system—especially the speed at which discoveries will take place—which means that instances of unsatisfying resource allocation will remain undetected for longer periods."*

Public officials do not face the necessary entrepreneurial incentives to *discover* situations where resources are misallocated (as seen from an omniscient being perspective). Policy responses to *already perceived* market problems often underestimate (for various reasons due to the nature of the policy process) the fact that the market process is continuously at work discovering opportunities for new gains from trade.

The time component of the entrepreneurial market process is crucial and cannot be neglected. This aspect of the entrepreneurial discovery process relates to the "responsiveness" of the market system. What matters to the efficiency of the market is that overlooked opportunities do not remain undiscovered for long. In other words, a more responsive system is more desirable (from the perspective of the participants in the market process) than a less responsive one. The speed at which profit opportunities will be discovered depends to a large extent on the quality of the incentives entrepreneurs face in the market.

When erecting barriers to the capture of profit opportunities, policy makers should realize that they weaken the quality of the economic system—especially the speed at which discoveries will take place—which means that instances of unsatisfying resource allocation will remain undetected for longer periods. A social tragedy occurs when unsatisfied needs could have been fulfilled through market exchange had the institutional context been more favorable to entrepreneurship.

B.4 Cultivate the cultural context and create the institutional conditions for entrepreneurship

Let us go back to the Crusoe example. Imagine that Crusoe holds deep personal beliefs about the sacredness of a species of tree on his island. Crusoe refrains from touching these trees and their fruit, for they are sacred. These trees cannot be chopped down nor can their branches lying on the ground be used. In our example, it happens that the tree branches at the bottom of the hole Crusoe fell into are made of that sacred wood. As a result, if Crusoe's own rules are binding, these resources are out of his reach. He cannot use these branches as means of ascent.

This example illustrates how the cultural context in which Crusoe's activity takes place frames his creativity. It may be the case that his belief is so strong that he would *never come to realize* that these branches could be used for his escape. For him these tree branches are simply not *seen* as potential resources at all. Crusoe's own belief frames the context in which the discovery of an opportunity for escape will be noticed and seized—i.e., what he is alerted to. In this specific example, Crusoe's belief may be responsible for his failure to survive his accident. The objective observer/scientist may not, of course, judge this failure as a "mistake" (because as an objective observer, he refrains from judging Crusoe's belief). But the observer certainly does take note of the cultural background, which explains Crusoe's non-survival. Crusoe's beliefs and cultural peculiarities are strictly his own, but their consequences are a legitimate subject for scientific inquiry.

Culture can shape what an individual perceives as opportunities and thus what he overlooks, as entrepreneurship is always embedded in a cultural context. Clearly, some cultural contexts are more conducive to entrepreneurial discovery than others. However, culture for the most part has to do with orientation (affecting where an entrepreneur may direct his gaze) and results in entrepreneurship looking differently across contexts. Moreover, culture is neither static nor deterministic; it evolves over time. As such, while some cultures hinder the development of entrepreneurship to a greater degree than others, this does not always remain the case.[18]

[18] For more on the issue of entrepreneurship and culture, see Don Lavoie (1991) "The Discovery and Interpretation of Profit Opportunities: Culture and the Kirznerian Entrepreneur" in B. Berger, ed., *The Culture of Entrepreneurship*, San Francisco: ICS Press. See also Virgil H. Storr (2006) "Weber's Spirit of Capitalism and the Bahamas' Junkanoo Ethic," *The Review of Austrian Economics*, 19 (4).

In the social case, in addition to personal beliefs, institutional conditions play a role in what entrepreneurs may be alerted to in their environment.[19] These institutional conditions comprise *de facto* social norms (i.e., the broader cultural context) as well as *de jure* rules enacted by governments; both being crucial to the outcome and nature of entrepreneurial activity.[20] A situation commonly found in many developing countries, for instance, is the existence of government institutions (e.g., regulations) that make market entry more costly than it would otherwise be. As a result many people may remain in the informal economy or avoid entering the market altogether. This means that potential entrepreneurs may not see profitable opportunities which are in fact available—opportunities which, if exploited, could drastically improve living conditions for the masses. Here the observer notes that the relevant institutional conditions are responsible for this (possibly disastrous) failure to improve living conditions. It is the duty of the observer to point out to society (and to policy makers) what the likely consequences are of alternative institutional arrangements.

It is in this sense that we emphasize that society's institutions—especially in so far as they affect the existence of monetary profit—may hinder or make possible the discovery process.[21] Well-defined and enforced property rights over resources are necessary for entrepreneurs to have a clear idea of the benefits and costs associated with their activities.[22] This also entails that when resources are un-owned, a process for defining property rights must be available (such as homesteading legalized through court decisions). Moreover, the possibility to freely contract over resources is an essential institutional element enabling entrepreneurial activity. Without freedom of contract, many discovered opportunities cannot be exploited. As we saw above, well-defined and enforced property rights as well as freedom of contract promote higher responsiveness to unsatisfying social conditions.

[19] On the relationship between culture and institutions, see for instance Peter Boettke "Why Culture Matters? Economics, Politics, and the Imprint of History," reprinted in Peter Boettke (2001) *Calculation and Coordination*, London: Routledge. Culture also matters because for entrepreneurship to occur, a certain level of social deviance must be acceptable.

[20] For an exploration of the subject see Peter Boettke and Christopher Coyne (2003) "Entrepreneurship and Development: Cause or Consequence?" *Advances in Austrian Economics*, vol. 6, 67-87.

[21] For an exploration of the subject see for instance William Baumol (1990) "Entrepreneurship: Productive, Unproductive, and Destructive" *The Journal of Political Economy*, 98(5), 893-921. See also Frederic Sautet (2005) "The Role of Institutions in Entrepreneurship," *Mercatus Policy Primer* No. 1, Mercatus Center, http://www.mercatus.org/pdf/materials/1053.pdf, for a more detailed presentation of the influence of the institutional environment on entrepreneurial activity.

[22] See Karol Boudreaux (2005) "The Role of Property Rights as an Institution," *Mercatus Policy Primer* No. 2, Mercatus Center, http://www.mercatus.org/pdf/materials/1160.pdf.

As we explained, the number of business start-ups occurring in an economy does not necessarily reflect its level of entrepreneurship. Rather, if one wants to know whether an economy is likely to promote high entrepreneurial responsiveness, then one should measure the level of economic freedom individuals enjoy. This economic freedom is measured by observing the *de facto* rules that individuals follow and the *de jure* context under which individuals and organizations operate. Empirically, more economic freedom is correlated with higher living standards. This is because more socially-beneficial entrepreneurial activity takes place in a freer environment.[23]

B.5 Remove legal barriers to market entry

Maintaining truly competitive markets is a desirable end for policy makers seeking a dynamic society, that is, an economy in which the speed of responsiveness to unsatisfying situations is high. In essence, competitive markets are the end-result of an institutional framework fostering entrepreneurship.

While the policy goal of maintaining competitive markets is shared among many policy makers, the policies in place often weaken the conditions for entrepreneurial activity. This is because competition law generally rests on a view of competition as a state of affairs. However, as seen above, competition is not a state of affairs but a process of entrepreneurial discovery. This means that the state of the market (e.g., the number of suppliers of a given commodity) cannot be used as an indication of the level of competition. This is also because in the marketplace, all products and services compete against each other.

For instance, electricity producers compete with wool makers in offering different means to reach a similar end: to stay warm in one's house. Moreover, because of entrepreneurial discovery, new means to stay warm are introduced in the market all the time: the polar fleece for instance, which is not made of wool but is a petroleum derivative. Traditional regulation of competition would see (a) polar fleece producers, (b) power-supplied heating, and (c) wool producers as operating in different markets (i.e., they would not be competing against each other).

Understanding competition as a process of entrepreneurial discovery shows the mistakes in this traditional approach. Competition exists among the three types of producers in so far as anyone is free to enter. The necessary and sufficient condition for free competition is the absence of extra-market barriers to entry (i.e., no privilege in the "heating mar-

[23] For measures of economic freedom, see James Gwartney and Robert Lawson (2005) "Economic Freedom of the World – 2005 Annual Report," *The Fraser Institute*, http://www.freetheworld.com/2005/2005_Full_Report.pdf. See also the World Bank *Doing Business Database*, which benchmarks business regulations around the world, http://www.doingbusiness.org/. For a general work on institutions and entrepreneurship, see David Harper (2003) *Foundations of Entrepreneurship and Economic Development*, London: Routledge.

ket" is given to anyone). In so far as anyone is free to offer goods and services to help someone stay warm, entrepreneurial competition takes place.

It follows that competition policy, as it is now practiced in most Western countries is, in the relevant sense, *anti*-competitive. Competition policy often frustrates the discoveries entrepreneurs generate by imposing an "ideal" design of the market. This may preclude free entry and may curtail freedom of contract (e.g., the blockage of mergers). Competition law regularly indicts market situations which are, from the perspective of entrepreneurial competition, perfectly competitive. Instead, policy makers should make sure that no extra-market privileges are given to any market participant and that freedom of entry is respected.[24]

B.6 Remove legal barriers to free trade

As the example of the buggy and the automobile shows, new products disrupt established production and consumption patterns. This disruption is also the sign that society's scarce resources were misused. It follows that protecting producers from the threats of competition (e.g., stopping anyone from replacing the buggy) or sheltering employees against the risk of losing their jobs (e.g., legislating against "abusive" lay-offs) stifles the entrepreneurial process which tends to replace less desired patterns of resource allocation by more desired ones.

The main victims, in addition to the entrepreneurs who are barred from capturing new profit opportunities, are consumers who do not benefit from the new gains from trade that entrepreneurs discovered. In essence, just as free entry is necessary to the entrepreneurial competitive process, free trade, either intra-national or international, is crucial to the ongoing improvement of consumer well-being. Free entry and free trade are two sides of the same institutional coin enabling entrepreneurial competition.

B.7 Main policy conclusions

It may be difficult for governments to implement policies fostering the entrepreneurial process because entrepreneurial activity cannot be directly measured. Policies that enable entrepreneurship to flourish are one-step removed from where entrepreneurial activity occurs, as they deal with the institutional and regulatory context.

In the search for the policies that foster entrepreneurship, policy makers should pay attention to:

a) the definition and enforcement of property rights (and the mechanisms that exist to establish property rights over previously un-owned resources);

b) the extent of the freedom of contract and its enforcement;

[24] For more on the subject of competition law, see, for instance, Dominick T. Armentano (1990) *Antitrust and Monopoly: Anatomy of a Policy Failure*, second ed., New York: Holmes & Meier. On the origins of competition law, see Werner Troesken (2002) "The Letters of John Sherman and the Origins of Antitrust," *The Review of Austrian Economics*, 15(4), 275-95.

c) the extent and predictability of government regulation (especially the extent of the freedom to enter and exit markets—including registration laws, bankruptcy laws, etc.—and the extent of the freedom to trade);

d) the size of the tax burden (especially *effective* marginal tax rates on capital and labor incomes, etc.); and

e) the general quality of government (including government's fiscal and monetary rules, the sizes of central and local government, and the extent and nature of the interaction of government with the private sector, such as procurement laws, etc.)[25]

The fundamental message of this Policy Primer is that the entrepreneurial discovery process matters more than available resources because it generates the socially-productive ideas necessary to all production. When policy makers focus on infrastructure, small business enterprises, regulation of markets, public scientific research, and more, they are in most cases ignorant of the nature of the process of entrepreneurial discovery. The use of resources is the *result* not the *cause* of entrepreneurial activity and economic development. In essence, what makes economic prosperity possible is the way resources are used, not the fact that resources are used in the first place.

The marvel of the competitive entrepreneurial process is its ability to reveal the knowledge necessary to a greater social coordination. The jeopardizing effects of policy and regulation may "manifest themselves in cases where there is an absence of coordination of which no one is aware. The point is that regulation may be responsible for such absences of coordination not being discovered."[26] The danger of regulation comes, not only because it disrupts the patterns of exchange between consumers and producers, but also, and primarily, because it weakens the entrepreneurial discovery process.[27]

Finally, understanding the difference between *de jure* and *de facto* rules is crucial to the good implementation of policy. The reason why policy changes do not always promote socially-beneficial entrepreneurship is because too often policy makers overlook the difference between what the law on the book says and the rules individuals actually follow.[28]

[25] See the *Doing Business Database*, op. cit.
[26] Kirzner "Competition, Regulation, and the Market Process: An 'Austrian' Perspective," op. cit., 7.
[27] For examples of the dangers of regulation, see Susan Dudley (2005) "Primer on Regulation," *Policy Resource No. 1*, Mercatus Center, http://www.mercatus.org/pdf/materials/1465.pdf. See also Sandy Ikeda (1996) *Dynamics of the Mixed Economy: Toward a Theory of Interventionism*, London: Routledge.
[28] For more on the subject, see Sautet, "The Role of Institutions in Entrepreneurship," op. cit.

CONCLUSION

In this Policy Primer, we explain that entrepreneurship derives from the creative power of the human mind and is the engine of the market process. We first illustrate that entrepreneurial activity occurs in the most basic context of a Crusoe economy. We then explain that it takes place in the social context of markets and may be manifest in many different circumstances (e.g., business start-ups, already established firms).

Entrepreneurship consists of the discovery of good ideas, i.e., noticing the potential for profitable ventures. We emphasize the distinction between the idea originating with the entrepreneur (i.e., the discovered idea) and the resources deployed to exploit the discovered opportunity (which we do not consider as entrepreneurship). The discovered idea (i.e., what consists of, strictly speaking, entrepreneurial activity) cannot be bought or acquired; it is not a resource—rather, it is what enables resources to be used. Markets "work" because the decentralized entrepreneurial process constantly reveals new good ideas to capture overlooked gains from trade. In this sense, entrepreneurship, rather than resources and their allocations, matters more to individual wellbeing and to prosperity.

In the social context, profit drives entrepreneurship by signaling a more desired way of organizing society's resources that market participants have hitherto overlooked. While alertness and discovery are the essential elements of entrepreneurship, technological innovativeness, boldness, and determination are also characteristics of entrepreneurial activity.

In order to foster socially-beneficial entrepreneurial activity, policy makers must pay attention to the quality of institutions—especially as they impact profits. Institutions that enable individuals to exercise their creativity to the fullest extent possible, by allowing them to discover opportunities and to reap the gains they have discovered, will foster an entrepreneurial society. It is only in the context of well-defined and enforced property rights that society can benefit from the fullness of entrepreneurial activity. Institutions should also include the freedom to contract over property rights and a limited interference from government with markets—especially regarding regulation and taxation.

Policy makers should not rely on the number of start-ups to judge the quality of the economic environment. Rather, they should look at measures of economic freedom and the quality of the institutional and regulatory environment. Economic freedom enables anyone to compete (i.e., to enter markets and create new ones) against already established producers. It is only through the freedom to enter markets that the full social benefit of entrepreneurship is realized.

About Mercatus

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society. Mercatus's research and outreach programs, Capitol Hill Campus, Government Accountability Project, Regulatory Studies Program, Social Change Project, and Global Prosperity Initiative, support this mission.

The Mercatus Center is a 501(c)(3) tax-exempt organization. The ideas presented in this series do not represent an official position of George Mason University.

About the Mercatus Policy Series

The objective of the Mercatus Policy Series is to help policy makers, scholars, and others involved in the policy process make more effective decisions by incorporating insights from sound interdisciplinary research. The Series aims to bridge the gap between advances in scholarship and the practical requirements of policy through four types of studies:

- **Policy Primers** present an accessible explanation of fundamental economic ideas necessary to the practice of sound policy.
- **Policy Resources** present a more in depth, yet still accessible introduction to the basic elements of government processes, or specific policy areas.
- **Policy Comments** present an analysis of a specific policy situation that Mercatus scholars have explored, and provide advice on potential policy changes.
- **Country Briefs** present an institutional perspective of critical issues facing countries in which Mercatus scholars have worked, and provide direction for policy improvements.

Mercatus Center
George Mason University

3301 North Fairfax Drive
Arlington, Virginia 22201
Tel: 703-993-4930
Fax: 703-993-4935