The Kirznerian Discovery Process, Entrepreneurship Externalities and Interventionism

Bogdan GLĂVAN
Romanian-American University
1B Expoziției Blvd., Sector 1, Bucharest, Romania
bogdan.glavan@gmail.com

Flavia ANGHEL
National University of Political Studies and Public Administration
30A Expoziției Blvd., Sector 1, Bucharest, 012104, Romania
flavia.anghel@facultateademanagement.ro

Abstract. *Entrepreneurship has received increasing attention in the literature after the fall of the communist regime in the 1990s. Especially the Hayekian perspective of the market process has been vindicated. However, Hayek's picture of the market process (as a decentralized device of collecting dispersed information) and Kirzner's description of the entrepreneurs (as agents who permanently search for new data and information, attempting to discover new profit opportunities) do not provide a realistic account of the functioning of markets. In fact, the Kirznerian analysis of entrepreneurship, which is supposed to provide a solid ground for supporting the virtues of the free market, came to serve as intellectual ammunition for the critics of the free market. But. the criticism fails to advance the case for interventionism*

Keywords: *entrepreneurship; entrepreneurship externalities; information externalities; economic development; Kirznerian discovery.*

Introduction

The debate on the role of the entrepreneur and the meaning of the market process has divided the modern Austrian School into two camps: the Misesian paradigm and the Hayekian paradigm (Salerno, 1993). Ludwig von Mises's disciples argue that a rational allocation of resources can occur only within the framework of private property and monetary calculation. Friedrich Hayek's followers, in particular Kirzner (1973; 1992), claim that the central problem in the allocation of resources is the dispersion of information among private economic agents.

Entrepreneurship has received increasing attention in the literature after the fall of the communist regime in the 1990s. Especially the Hayekian perspective of the market process has been vindicated. However, Hayek's picture of the market process (as a decentralized device of collecting dispersed information) and Kirzner's description of the entrepreneurs (as agents who permanently search for new data and information, attempting to discover new profit opportunities) do not provide a realistic account of the functioning of markets and do not defend economic freedom against state interventionism.

One could be surprised to learn that the Kirznerian analysis of entrepreneurship, which is supposed to provide a solid ground for supporting the virtues of the free market, came to serve as intellectual ammunition for the critics of the free market. Yet this is exactly what happened. Hausmann and Rodrik (2003) and Rodrik (2004; 2005) use the entrepreneur-as- "discovery maker" paradigm in order to advance a claim that is at odds with the traditional argument for free markets. These writers maintain that the social benefits arising from entrepreneurial actions are greater than the private gains. Entrepreneurs who discover profit opportunities signalize to other entrepreneurs the efficient path of investments and the latter can imitate the former acting upon this information. Market failure to internalize this information externality creates a useful role for the state, which can provide adequate incentives by subsidizing investment in new projects.

Market failure reloaded: information externalities

The idea that entrepreneurship consists of discovering profit opportunities has inspired the claim that entrepreneurship should be therefore subsidized. The reason is the following: those who are alert and manage to find new business opportunities send, by their own achievement, a signal to everybody else, who now become aware of the new sources of profit and will start to exploit it for themselves. This is called the information externality in entrepreneurship. As a result of this externality, the initial successful entrepreneur cannot reap all the gain from his discovery; the profit will diminish quickly as more and more people will learn the new information and begin their own business (Hausmann & Rodrik 2003, 2005; Iyigun & Rodrik 2004; Rodrik 2004; Acs, Audretsch, & Lehmann 2013; Ghio, Guerini, Lehmann, & Rossi-Lamastra (2015). Various authors (Karro et al. 2017; Mariussen et. al. 2019), have attempted to explore how this phenomenon can be alleviated by government intervention.

In the words of Rodrik (2004, p.9), the entrepreneurial activity "is an activity that has great social value and yet is very poorly remunerated. If the entrepreneur fails in his venture, he bears the full cost of his failure. If he is successful, he has to share the value of his discovery with other producers who can follow his example and flock into the new activity. In the limit, with free entry, entrepreneurship of this kind produces private costs and social gains." So the government should step in and subsidize entrepreneurship.

This case for government intervention has its roots in the writings of Kirznerian-inspired authors like Audretsch and Keilbach (2004), Holcombe (1998; 2003a; 2003b), Minniti and Koppl (1999) and Minniti (2003), who have developed the idea that entrepreneurship has positive spillover effects, by conveying information about market opportunities and, consequently, breeding more entrepreneurship. Apparently, critics of free-market had no difficulty to finesse this idea away from the above-mentioned writers and use it as justification for government intervention in promoting entrepreneurship.

As Hausmann and Rodrik (2003, p. 4) argue, "the initial entrepreneur who makes the "discovery" can capture only a small part of the social value that this knowledge generates". Kirzner (1973, p.74) presents a similar perspective on entrepreneurship: "In economic development, too, the entrepreneur is to be seen as responding to opportunities rather than creating them; as capturing profit opportunities rather than generating them… Without entrepreneurship, without alertness to the new possibility, the long-term benefits may remain untapped".

Boettke and Coyne (2005, pp.207-208) hold, in essence, an equivalent view: "Entrepreneurship cannot be considered a pure public good. Returning to the public good criteria established above, there are aspects that are both rival and excludable. However, there are significant benefits in terms of spillover that are non-rival and non-excludable […] The activity of one entrepreneur also benefits other entrepreneurs in another fashion: the dispersion of knowledge throughout the market."

Also, Minniti (2003, p.6) adopts a similar perspective: "In fact, economic action does not take place in a social vacuum but rather is embedded in networks of social relationships. I argue that the presence of other entrepreneurs reduces ambiguity and allows the entrepreneur to concentrate more on her chosen activity. Such influence may be modeled as a network externality in which entrepreneurship is assumed to exhibit increasing returns with respect to adoption. The externality under consideration is a nonpecuniary externality […] We may call it a perceptual externality."

The Kirznerian view on entrepreneurship and its externalities

The externality in entrepreneurship argument is built around the idea that entrepreneurs who discover new business opportunities signal to others the opportunity to extend their own businesses. Rodrik's entrepreneur bears a strong resemblance to the entrepreneur modeled by Schumpeter (1961) and Kirzner (1973). The idea that entrepreneurial initiative paves the way for additional entrepreneurial initiatives has been accepted by Romer (1986; 1990) and developed by Holcombe (1998). As the latter stated, "Where do entrepreneurial opportunities come from? Many of them come from the actions of other entrepreneurs… when entrepreneurs take advantage of some profit opportunities, the economic environment changes, creating with it additional opportunities. Thus, entrepreneurship leads to more entrepreneurship" (Holcombe, 1998, pp.50-54). Boettke and Coyne (2005, p.11, footnote 7) endorse this idea: "The entrepreneurial aspect of human action is, in a sense, self-sustaining since it creates an environment of further discovery".

This process of knowledge spillover represents the basis for Hausmann and Rodrik's assertion that the state should mitigate the problem of informational externalities by supporting the entrepreneurial initiatives. While these two authors use the knowledge spillover idea explicitly to advocate state interventionism, they are hardly original in noticing the implications of Holcombe's view of entrepreneurship. Hülsmann has grasped the fact that this policy conclusion follows naturally from adopting a passive view of man.

To their merit, Boettke and Coyne (2005, p.209) attempt to mitigate the claim that externalities have a negative effect on entrepreneurship: "A certain narrow reading of economic theory might suggest that, since the individual entrepreneur does not capture or internalize all the benefits from his activity, entrepreneurial activities will be undersupplied. But it must be realized that this does not mean that most of the benefits are not internalized. In fact, […] our historical experience with markets defies what narrow economic theory might dictate. Entrepreneurs capture profits by exercising the knowledge they have of 'time and place' and revealing the information they are in possession of through their actions in the marketplace. It is true that, once entrepreneurs introduce a good to the market, others outside the exchange will benefit. It is true also that, once entrepreneurs reveal information, it is in a fundamental sense now publicly available and free to others. However, as long as the private benefits are large enough, even if all the benefits are not internalized, we will still get the efficient level of entrepreneurship." (my emphasis)

A more fundamental observation (Glăvan, 2007) points to the fact that the knowledge spillover, although impossible to deny, is hardly relevant for actual successful entrepreneurship. This is true because every entrepreneurial act is unique; economic agents act not on the base of past information about market conditions, that is, on the knowledge which was previously spread onto them, but according to their expectations about how market conditions will be in the future. Thus, profit opportunities discovered by somebody do not automatically translate into a profitable business for others; it is impossible to differentiate ex-ante between „false flags" and really valuable knowledge that can be used (to a limited extent) by other market participants.

Criticism of government intervention

Hausmann and Rodrik acknowledge the criticism some free market-oriented economists (of Hayekian-kirznerian inspiration) have raised against government intervention. According to the latter, the central problem of policymakers is the failure to collect information about the most effective employment of existing resources. Compared to private entrepreneurs, policymakers have no superior knowledge of what investment projects should be undertaken in order to maximize growth. Rodrik's reply is awkward: "For example, the typical riposte about governments' inability to pick winners becomes irrelevant. Yes, the government has imperfect information, but as I shall argue, so does the private sector" (Rodrik 2004, p.3).

The author's view on the matter is both devastating for these free-market advocates and naïve – as far as his grasp of reality is concerned: "Just as discovering underlying costs require entrepreneurial experimentation, discovering the appropriate ways in which restructuring bottlenecks can be overcome needs a trial-and-error approach to policymaking" (Rodrik 2004, p. 19). But this line of reasoning has deep and dangerous consequences. It results, for example, that one could defend socialism for the same reason that Rodrik defends industrial policy (socialism is, after all, an all-encompassing allocation of resources using political means), namely because central planners need to allocate resources using a trial-and-error process. Therefore, the success or failure of socialism is always an empirical matter. And somebody could claim, for instance, that socialism in Romania did not exactly fail, and that it could eventually succeed if only the process of "experimentation" was continued.

The public choice critique of interventionism is also rapidly dismissed: "Similarly, the idea that governments need to keep private firms at arms' length to minimize corruption and rent-seeking gets turned on its head. Yes, the government needs to maintain its autonomy from private interests. But it can elicit useful information from the private sector only when it is engaged in an ongoing relationship with it" (Rodrik, 2004, p.4).

Even if Rodrik manages to avoid the critiques raised by some free-market champions, his case for industrial policy is by no means flawless. In fact, his efforts succeed only in pointing out the weaknesses of conventional defenses of the free market. But all arguments presented by the author have been essentially anticipated, discussed and refuted by Austrian economists.

As Rodrik observes, the free market cannot be defended successfully by pointing out that policymakers do not possess enough information to allocate resources optimally, or by emphasizing the corruptive nature of the state. Perhaps government bureaucrats are both smarter (and better informed) than private entrepreneurs, and well-intended. This hypothesis is, of course, completely imaginary, despite Rodrik's attempts to find historical cases supporting his claim. But this assumption should not be dismissed only because it is empirically irrelevant. Government interventionism has to be criticized granted that policymakers are morally and intellectually the best members of society.

The problem with state interventionism is deeper than incentives and information-based considerations usually show. Starting with Mises (1990), a large Austrian literature argued that in the absence of private property, money prices cannot emerge and economic calculation is impossible. At the limit, in a socialist commonwealth, the central planner has no rational way to decide whether to shift resources from project A to project B. Its intervention is arbitrary because it cannot be subjected to the profit and loss test, as private activities are. As Rothbard (1962, p.825) observed, any punctual decision to socialize investment introduces an island of calculation chaos in the market economy.

Arguing that market forces cannot provide an adequate level of entrepreneurship, Hausmann and Rodrik reject, in fact, the profit or loss principle as a general guide for the allocation of resources. But, then, we are left with no rational solution to issues like how much should the state pump in specific investment projects, or how should the entrepreneurs be selected. The only possible reply is that the answer depends only on the subjective preferences and judgment of Rodrik's smart bureaucrats.

Conclusions

In this paper, we have tried to show how a particular view on entrepreneurship has paved the way for government interventionism. Hausmann and Rodrik's new argument of market failure does not enrich the understanding of how entrepreneurship contributes to economic development. If any, the merit of these writers' argumentation is that it serves to uncover weaknesses in the argumentation of some free-market advocates. But it fails to advance the case for industrial policy.

References

Acs, Z., Audretsch, D., & Lehmann, E. (2013). The Knowledge Spillover Theory of Entrepreneurship. *Small Business Economics 41(4)*, 757-774. doi: 10.1007/s11187-013-9505-9.

Audretsch, D.B., & Keilbach, M. (2004). The Knowledge Spillover Theory of Entrepreneurship and Technological Diffusion. Paper presented at the Colloquium on Entrepreneurship Education and Technology Transfer. Max Planck Institute for Research on Entrepreneurship. Growth and Public Policy, Indiana University. December

Boettke, P.J., & Coyne, C.J. (2005). Concerting Entrepreneurship: An International Public Good. In Padoan. P.C. & Boyd. G. (eds.), *Structural Partnering for a New Atlantic Economy: Complementary Entrepreneurship for Balanced Interdependence*. Edward Elgar

Boettke, P., & Coyne, C. (2003). Entrepreneurship and Development: Cause or Consequence. *Advances in Austrian Economics* 6, 67-87.

Ghio, N., Guerini, M., Lehmann, E. E., & Rossi-Lamastra, C. (2015). The emergence of the knowledge spillover theory of entrepreneurship. *Small Business Economics, 44(1)*, 1–18. doi: 10.1007/s11187-014-9588-y.

Hausmann, R., & Rodrick, D. (2003). Economic Development as Self-Discovery. *Journal of Development Economics, 72(2*), 603-633.

Hausmann, R., & Rodrik, D. (2005). It Is Not How Much but What You Export That Matters. Working Paper. November. Harvard University. Retrieved from http://ksghome.harvard.edu/~drodrik/papers.html.

Holcombe, R.G. (1997). A Theory of the Theory of Public Goods. *Review of Austrian Economics, 10*(1), 1-22.

Holcombe, R.G. (1998). Entrepreneurship and Economic Growth. *Quarterly Journal of Austrian Economics 1(2)*, 45-62.
Holcombe, R.G. (2003a). The Origins of Entrepreneurial Opportunities. *Review of Austrian Economics 16(1),* 25-43.
Holcombe, R.G. (2003b). Progress and Entrepreneurship. *Quarterly Journal of Austrian Economics 6(3)*, 3-26.
Hoppe, H.H. (1998). The Intellectual Cover for Socialism. *The Free Market* (February).
Hülsmann, J.G. (1999). Entrepreneurship and Economic Growth: Comment on Holcombe. *Quarterly Journal of Austrian Economic 2(2),* 63-65.
Iyigun, M., & Rodrik, D. (2004). On the Efficacy of Reforms: Policy Tinkering. *Institutional Change. and Entrepreneurship.* NBER Working Paper 10455.
Karro, E., Kattel, R., & Cepilovs, A. (2017). Can Smart Specialization and Entrepreneurial Discovery be Organized by the Government? Lessons from Central and Eastern Europe. In Radosevic S. (ed.) *Advances in the Theory and Practice of Smart Specialization*, Academic Press, pp. 269-292. doi: 10.1016/B978-0-12-804137-6.00013-9
Kirzner, I. (1973). *Competition and Entrepreneurship*. Chicago, IL: University of Chicago Press.
Kirzner, I. (1992). *The Meaning of the Market Process.* London, UK: Routledge.
Mariussen, A., Virkkala, S., Finne, H., Aasen, T.M. (eds.) (2019). *The Entrepreneurial Discovery Process and Regional Development.* New York: NT: Routledge. doi: 10.4324/9781351273763
Minniti, M., & Koppl, R. (1999). The Unintended Consequences of Entrepreneurship. *Journal des Economistes et des Etudes Humaines 9(4),* 567-586.
Minniti, M. (2005). Entrepreneurship and Network Externalities. *Journal of Economic Behavior & Organization 57(1),* 1-27.
Mises, L. von (1990). *Economic Calculation in the Socialist Commonwealth*. Auburn: Al. Mises Institute.
Rodrick, D. (2004). Industrial Policy for the Twenty-First Century. Working Paper. October, Harvard University.
Salerno, J. (1993). Mises and Hayek Dehomogenized. *The Review of Austrian Economics 6(2),* 113-146.
Schumpeter, J.A. (1961). *The Theory of Economic Development*. New York NY: Oxford University Press.