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Israel M. Kirzner

Israel M. Kirzner is professor of economics at New York University. He is the author of *Competition and Entrepreneurship*; *Perception, Opportunity, and Profit*; and *The Perils of Regulation: A Market-Process Approach*.

Executive Summary

To the layman untrained in economics, the market economy presents a bewildering face. It consists of numerous individuals each intent on his own goals, giving no concern to the overall social implications of his pursuits. No central coordinating agency controls or even monitors the innumerable independent production and exchange decisions made by these countless individuals. It is no wonder that the market economy seems to be nothing but a jungle of clashing, discordant individual activities. From this perspective, government regulation fills a simple and obvious need: to introduce a modicum of coordination into these otherwise chaotic conditions. What is obviously needed to save people from the disastrous results of their working at cross-purposes is the guidance of an agency equipped with the necessary power, knowledge, and motivation to foster harmony.

Ever since Adam Smith, of course, economists have rejected this untutored view of the market. Despite drastically differing assessments of the usefulness of government regulation, economists have, within a variety of paradigms, been compelled to take at least some account of those regularities in markets which, for Smith, reflect the benign results of the "invisible hand." In the modern debates over regulation the best-known criticisms of government regulation have come to be associated with one particular ("neoclassical") paradigm. This article, too, will offer a view seriously questioning the functions of regulation, but one that emerges from a second, "Austrian" paradigm. We shall have to spell out more carefully some of the differences between these two perspectives, but we may put the essence of the difference quite concisely. From the better-known neoclassical perspective, government regulation is suspect because the unconstrained results of the operation of free markets are, in some sense, benign. From the Austrian perspective, on the other hand, regulation is challenged on the basis of insights concerning the (relevantly) benign character of the free market process. Although both dismiss the naive view of the market as chaotic, there is a world of difference between these two types of challenge to government regulation. It should be noted that for both, whether based on "benign results" or on "benign process," the general criterion for benignity is held to be the extent to which satisfaction of individual goals is achieved. There are indeed troublesome theoretical ambiguities embedded in this criterion, but for our purposes these may be set aside. The point is that in questioning government regulation, the economist makes no claim for the ultimate moral benignity of market process, or of its results; the relevant issue is strictly the effectiveness with which the system serves the goals of its individual participants.

Market Results

The benign-results critique of government regulation stems from the belief that markets can at all times be reasonably assumed to be at or close to competitive equilibrium. The market system is taken to be so efficient as to ensure that at

all times prices are approximately at the levels necessary to clear their respective markets. Far from being chaotic, the market is seen as a powerful coordinating institution that matches up would-be buyers with would-be sellers, ensuring that all feasible, mutually beneficial exchange opportunities are successfully consummated. Shortcomings alleged to be visible in the market allocation of resources are, in this view, seen as shortcomings only by those who disagree with consumer preferences, or who fail to understand the inescapable constraints imposed by scarcity. Even if we are prepared to attribute the most disinterested and selfless of motives to the regulators, to tamper with the benign results attributed to the market must be to divert the course of production, of the allocation of resources, from the channels marked out by the preferences of market participants themselves (in the light of given resource endowments) to other arbitrarily imposed -- "less benign" -- channels. In this view, the precise sequence of market events through which equilibrium within and between markets might be achieved is of less significance than the circumstance that such balance may at all times be considered to have already been approximately achieved.

In order to conclude that the results of the market are indeed benign, this view relies heavily on the assumption of perfectly competitive markets. The equilibrium held to be approximately attained in and between markets is the perfectly competitive market equilibrium -- and it is the favorable evaluation of competitive equilibrium by welfare economics that informs the anti-regulation conclusions of this view. It is not surprising that economists supporting government regulatory policies have, without need to reject the equilibrium view of markets, nor the welfare theorems to which the policies are linked, simply been able to point to the highly specific assumptions needed before a favorable verdict on the unregulated market can be pronounced. And perhaps the most important of these assumptions has indeed been that of perfect competition -- that the market consists of so many small buyers and sellers that for each of them the market price may be taken as a datum, not affected by the pricing, output, or purchase decisions of any one of them. This specific assumption fails to fit the facts of modern markets. This is so obviously true that many economists, precisely because they have, on market equilibrium grounds, generally looked with disfavor upon government regulation, have nonetheless frequently considered it desirable that the government intervene to guarantee a reasonable approximation of perfectly competitive conditions.

It is not necessary to dwell on the pointed questions that proponents of regulation can raise, and have raised, against this view (with respect both to the relevance of the assumptions necessary for this view to be tenable and to the validity of the thesis that markets successfully equilibrate). So we turn now to the Austrian critique of regulation.

The Market as Process

In this second view it is not claimed that at any given time the market has attained even an approximation of the equilibrium state. It is merely argued that wherever equilibrium conditions have not yet been fulfilled, this very circumstance creates incentives for systematic changes that tend to eliminate the existing imbalances. The case against the regulation of the market (even by well-meaning and conscientious public servants), rests upon insights into this corrective process and into its socially benign character. Long before this corrective process can possibly lead to even approximate coordination, changes in the basic data of the market (individual preferences, the endowments of resources, and available technology) will have rendered the hypothesized state of full equilibrium (defined with respect to the initial state of the data) utterly irrelevant. But the discrepancies continually stimulate, in turn, changes in these existing patterns of resource allocation.

Emphasizing the properties of the process market transactions make up, rather than the allocative pattern achieved by the process, underscores the complete irrelevance of utopian notions of perfect coordination. In this view of the market economy, to judge a real-world economic system against the yardstick of perfect coordination is not merely to treat far too seriously the possibility of perfect coordination (and thus of markets in full equilibrium) it is grossly to misunderstand the essential economic problem faced by complex societies. The truth is that, as Hayek explained four decades ago, the economic problem faced by society consists of the need to ensure that, as far as possible, the available bits of scattered knowledge of separate individuals be somehow mobilized to contribute to relevant decisions that affect the societal pattern of resource allocation. To try to measure the success with which a society addresses its economic problem, with a yardstick reflecting a pattern appropriate to hypothesized centralized omniscience, is akin to an attempt to assess the efficiency of an allocation pattern for scarce resources by comparing its results with those that might be imagined for a world in which scarcity is absent: The whole problem is how best to cope with scarcity. Similarly the socio-economic problem is how best to cope with the inescapable decentralization of knowledge.

Given the irrelevance of using the omniscience yardstick and the complications that compound the economic problem facing society when the consequences of kaleidic change in the basic data are taken into account, it becomes clear that a normative criterion other than perfect coordination must be found. The "process" view suggests that the appropriate criterion should be sought in the capacity attributed to the market process, of serving as a "discovery procedure" (the phrase is Hayek's). What occurs during the market process of interacting individual decisions, Hayek argues, is that participants tend to discover relevant aspects of each other's abilities and desires. Here, then, we have a relevant conceptual yardstick by which to assess both the operation of a market economy and policy recommendations made to modify its operation. Our question need never be: Are the results of the market process such that there is nothing remaining yet to be discovered, or even reasonably close to such a state? Rather, we must ask: Can the institutional structure (or proposed modifications to it) stimulate a reasonably steady and significant flow of (correct) mutual discoveries? To the extent that positive answers to this question can be provided, we have identified a socially "benign" process. To the extent that a proposed modification enhances the propensity of the system to stimulate (correct) discoveries, it represents a "benign" proposal; on the other hand, if the proposal is likely to hamper or distort the discovery procedure, it is "harmful."

Of course, the adoption of the process approach does not mean that we are entirely uninterested in results. After all, the effectiveness with which the process stimulates discoveries may be able to be gauged, in part, by observing results. But even where this is the case, results are referred to not because of the absolute desirability of the pattern of allocation that they display, but because of the extent of the already-made discoveries that they reveal. Let us see how, from the process perspective, the market economy successfully coordinates the activities of its participants.

The Market as Discovery Procedure

In a market economy decisions are made independently by many market participants in their capacities as consumers, owners of resources, or as entrepreneur-producers. These decisions are made on the basis of what individuals think are the best options available to them. Since the available options will themselves be the results of the individual decisions of others, individual decisions are being made on the basis of assessments of the anticipated individual decisions of others. These assessments are clearly likely to be in greater or lesser error. Buyers may offer high prices because they erroneously believe that no one is able or prepared to sell for less. Sellers offer to sell at low prices because they think no one is prepared to buy for more. Producers refrain from producing an item because they mistakenly believe that the resources needed to produce it can only be obtained at a cost that would place the product out of the reach of potential consumers. Or they produce a second item at a high cost because they think potential buyers are more eager to buy it. And so on.

Each of these mistaken decisions will systematically tend to bring about rather specific kinds of consequences. Overestimating a product's appeal to consumers will result in market losses. When a producer overestimates production costs or underestimates a product's appeal to consumers, he overlooks opportunities to make a profit that will tend to attract more perceptive entrepreneurs. As a result of these elementary and well-known kinds of profit or loss experiences, market participants learn to assess more accurately the limits of possible, mutually beneficial transactions with their fellow participants.

Note that we do not say that these disappointments and profit discoveries eliminate all the errors that have been made. We say merely that market activity based on error generates the incentives and the experiences that tend to identify where the errors have been made, and to stimulate less erroneous activity. A seller who is disappointed in his expectation of securing a high price will learn that he can expect, at best, only a lower price. A seller who has accepted a price lower than the price being paid by buyers elsewhere in the market helps create a situation in which the same item is being traded at two different prices -- thus offering the opportunity to alert entrepreneurs to buy at the lower price and resell at the higher price. Such clearcut opportunities for pure profit tend to attract attention, to become exploited and thus eliminated -- in the course of which the initial error itself is likely to be corrected. The sequence has an almost poetic quality: 1) errors manifest themselves in the creation of profit opportunities or of experienced disappointments; 2) profit opportunities tend to be discovered and exploited; disappointments tend to give overly optimistic market participants more realistic information; these tendencies combine towards 3) the elimination of the initial errors (and of the profit opportunities and the disappointments which they generated). The impetus toward mutual discovery is provided by the market consequences of the initial discovery-failures.

Profit, Entrepreneurship, and the Discovery Process

It is important to notice the role played in this process of market discovery by pure entrepreneurial profit. Pure profit opportunities emerge continually as errors are made by market participants in a changing world. The inevitably fleeting character of these opportunities arises from the powerful market tendency for entrepreneurs to notice, exploit, and then eliminate these pure price differentials. The paradox of pure profit opportunities is precisely that they are at the same time both continually emerging and yet continually disappearing. It is this incessant process of the creation and the destruction of opportunities for pure profit that makes up the discovery procedure of the market. It is this process that keeps entrepreneurs reasonably abreast of changes in consumer preferences, in available technologies, and in resource availabilities.

As we have noticed, profit opportunities reflect price discrepancies. And, indeed, such price discrepancies reflect past error. But the profit opportunity so created exerts a powerful, attractive force upon entrepreneurial alertness. While, in general, error by itself may appear likely to stimulate its own correction, the error that generates pure profit opportunities makes entrepreneurs more aware of these opportunities, thus stimulating its own elimination.

Our conviction that opportunities for pure profit will tend to be pounced upon by alert entrepreneurs should not, of course, be distorted to suggest that pure profit opportunities will, at all times, have already been pounced upon before they have even emerged. Entrepreneurial error is continually with us. On the other hand, neither should the perennial existence of error suggest that no systematic market forces are present tending to its elimination. The driving force behind the market process of continual discovery of continually emerging error is entrepreneurial alertness. The truth is that we (whether economists, or psychologists, or businessmen) know very little about the sources and the nature of entrepreneurial alertness. But we know enough to understand that the market depends upon it for its remarkable ability to serve as a social discovery procedure. If, as we wish to claim in this article, the free market must depend only on this entrepreneurial discovery process for its socially benign character, it behooves us as policymakers to understand thoroughly the subtle aspects of this process and to take every step possible to avoid hampering or distorting its course.

Entrepreneurial alertness is not confined to noticing already existing price differentials. Entrepreneurial alertness goes far beyond the exploitation of perceived opportunities for instantaneous arbitrage in today's markets. The speculative entrepreneur who, anticipating a rise in price of a particular item, buys now at the low price in order to reap pure profit by selling tomorrow, or in 20 years' time, is acting upon the stimulus of his "alertness" to an absence of coordination between what is available today and what will be needed tomorrow, or in 20 years' time. If this speculative entrepreneur turns out to have been correct, this absence of coordination will be seen retrospectively as arising out of the errors of those others who failed to anticipate correctly the future market trends. It was their error that created the intertemporal price discrepancy that attracted the notice and interest of the successful speculator-entrepreneur.

And we may take the matter even further. Not only may the intertemporal profit opportunity be noticed by the speculator, he may in fact create it. The imaginative, innovative entrepreneur who buys today's resources cheaply in order to market tomorrow, or in 20 years' time, a totally new idea, has acted to bring the allocation of society's resources into greater coordination with the true possibilities that his own creative genius reveals already to exist. From a historical perspective, what would be revealed as the "errors" of those earlier generations who had not yet dreamed of the potential discoveries "waiting" to be made are "corrected" through the creative process of entrepreneurial innovation. No matter whether entrepreneurial alertness manifests itself in the perception of arbitrage opportunities, or of purely speculative opportunities, or of opportunities for technological or marketing innovation, it is this alertness that drives the corrective discovery process of the market.

Competition and Entrepreneurship

We should notice, in addition, that the entrepreneurial discovery process constitutes an essentially competitive process. This crucially significant insight deserves brief elaboration.

As we have seen, the dynamic of the market process comes from the implementation of entrepreneurial discoveries. For such implementation it is necessary, of course, that entrepreneurs be free to act upon their discoveries -- no matter

how this may redound to the disadvantage of those who have not themselves made these discoveries. Such freedom to act requires that no entrepreneur be blocked from entry into any line of market endeavor. Freedom of entry is the legal and institutional prerequisite for the discovery procedure of the market.

It is easy to see how freedom of entry for alert entrepreneurs who think they have discovered opportunities for pure profit must be a source of fear to those whose "errors" have kept consumers less well-served than they might have been. For those selling at high prices (when the same item is available at lower prices), the competition of arbitrageurs spells a rapid end to their high prices. (For those buying at the lower prices this competition from arbitrageurs spells a similar threat.) For those using scarce resources to produce a product less urgently needed by consumers than a second product (producibile with the same resources) not now being produced, the competition of the innovative entrepreneur who comes to bid for these scarce resources in order to produce the second product must indeed seem a most serious competitive threat. For each of those threatened, it would seem eminently desirable that these brash, innovative, iconoclastic, and disrespectful entrepreneurs be prevented from entering -- and disrupting -- these existing markets. Clearly the dynamic of entrepreneurial discovery operates by continual disruption of the quiet life that would, in its absence, be enjoyed by those pursuing established (and partially "erroneous") patterns of market behavior.

In the sense in which businessmen understand the meaning of competition, the entrepreneurial discovery-process of the market is essentially competitive: It operates only insofar as no one in the market is protected against the entry of newcomers. The freedom to enter not only makes potential entrants more alert to "gaps" -- areas of potential profit; the awareness of such freedom will also make incumbents more alert to threats of potential entry. The incumbents will then seek to forestall entry by appropriate, "entrepreneurial" modification of their own activities.

To stimulate the alertness of entrepreneurs in this way -- that is, to guarantee the competitive character of the market process -- we do not need to postulate that the market for any particular item already includes a large number of buyers and sellers. We certainly do not need to postulate -- as the more traditional terminology of technical economics has assumed is necessary for the existence of perfectly competitive conditions -- that each market participant views himself as powerless to choose his price bids or offers. All we need to postulate is that there exist no extra-market barriers to the entry of potential competitors to any particular line of endeavor. In arguing that the benign properties we have attributed to the market process depend upon its competitive character, we do not mean that these properties rest upon the outcome of a competitive process, during which so many market participants have entered as to render each of them atomistically impotent. What we are saying is that the conditions which stimulate the competitive process -- i.e., the complete absence of institutional restrictions upon entry -- tend to guarantee the mutual discovery process.

Government Regulation - Obstacle to the Discovery Process

We are now in a better position to see how the Austrian view of the market outlined in this article may lead to a critical stance toward government regulation, and how the basis for such a critical stance differs from that of the more orthodox, neoclassical defense of the free market. We may put the matter quite succinctly: For reasonably successful coordination within a decentralized decision-making system, the discovery process constituted by competitive-entrepreneurial alertness to profit opportunities is crucial. Attempts at improvement by direct regulation are likely to be based on erroneous information (because the regulators cannot utilize the discovery process of profit pursuit) and are likely to block or distort the market's own delicate discovery process.

Let us suppose that the need to regulate is asserted on the basis of some perceived "undesirable" phenomenon arising from the unregulated market. For example, the prices of certain goods are held to be "too high" (milk to consumers?), or "too low" (wheat prices received by farmers?). Or the quantity available of a certain product is held to be "too low" (medical care?) or "too high" (unsafe toys?). And so on. Let us imagine (perhaps fancifully) that government decisionmakers are motivated solely by the urge to induce a pattern of phenomena that faithfully reflects consumer preferences (which they believe to have been somehow frustrated by the uncoordinated free market). Our discussion should have made clear that these selfless, public-minded officials lack the means to be able to respond to the innumerable rankings of preference (by consumers and owners of resources) of which they may initially not be directly aware. There is no way they can know the "correct" price or the "correct" quantity for any particular product or resource. There is nothing (corresponding to the entrepreneurial motive to discover pure profit opportunities) that could lead them systematically to -discover where failures of coordination in fact exist.

More serious is the fact that direct controls by government on prices, quantities, or qualities of output production or input employment may unintentionally block activities which have, as yet, not been specifically envisaged by anyone. Where these blocked activities turn out to be entrepreneurially profitable activities (perhaps as a result of unforeseen changes in data), the likelihood of their being discovered is then sharply diminished. Without necessarily intending it, the spontaneous discovery process of the free market has thus been, to some extent, stifled or distorted.

We saw earlier how important for the competitive-entrepreneurial discovery process is the potential for unfettered entry by profit-seeking entrepreneurs into existing markets. Inevitably, government regulatory restrictions block such entry. In the relevant sense, such restrictions are anti-competitive. They tend to frustrate the discoveries that the competitive process is likely to generate. Even where government regulation (perhaps inspired by a mistaken ideal of "competition" in which any significant size is suspect *per se*) is designed to "maintain competition" (e.g. by blocking mergers), this too must be set down as anti-competitive. For example, this may block the entrepreneurial process by which the optimum scale for the producing firm might be discovered.

It is easy for competent government officials to imagine that they know what is good for the economy. But this is likely to mean that in the incredibly complex economies of our time, it is easy for well-meaning individuals not to realize their ignorance in specific instances. For private entrepreneurs, the device for the communication of such unsuspected missing information is provided by the attractiveness of the opportunities for pure profit which such missing information generates. Not only are regulators unable to benefit by such profit-inspired discoveries; their direct intervention in the marketplace can hardly fail to frustrate, stifle, and distort the socially benign discovery process that depends on freedom of entry into branches of activity for which the social desirability has not yet been established.

It follows that the harmful effects of regulation (as judged from the perspective of consumer preferences, not from that of arbitrarily-adopted canons of social importance) are not necessarily found in palpable failure (as expressed, for example, in shortages, or gluts, or other "obvious" absences of coordination). The harmful effects of regulation also 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. The marvel of the competitive-entrepreneurial market is its ability to inspire coordinative activities the very need for which would, in the absence of the market, never be revealed.

Indeed, the "invisible hand" of the free market is invisible also in the sense that the very problems of coordination it tends to solve are invisible even to the most dedicated of scientists -- or government regulators.

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