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Israel Kirzner's Entrepreneurship

The purpose of this essay is to show the procedure that Israel Kirzner uses to derive his definition of the entrepreneur. I begin with a brief summary. Kirzner's procedure is based on *an analogy*, or parallel, between what he calls the entrepreneurial element in individual decision-making and entrepreneurship in the market interaction (1973: 31; 1979: 172; and 1982). Accordingly, his first step is to discuss individual action. He isolates the entrepreneurial element by contrasting routine optimizing behavior with what he claims we can know about true individual action by means of a closer inspection. To Kirzner, closer inspection reveals that individuals spontaneously discover means of satisfying their wants. For example, an individual might follow a subconscious hunch and, as a result, experience an unexpected gain. He calls such spontaneous discoveries the entrepreneurial element. Another term he uses is *alertness to hitherto undiscovered opportunities*.

Second, he performs an analogous contrast to isolate entrepreneurship in the market. Here he contrasts what he calls Robbinsian economizers with the actors in the market economy who possess the entrepreneurial element of individual decision-making. Third, he identifies what he regards as a crucial kind of action in a market economy -- arbitrage. He associates entrepreneurship in the market economy primarily with this action. Finally, he argues that just as the entrepreneurial element in individual decision-making leads to a more efficient personal allocation of resources, or coordination of the individual's plans, so also does entrepreneurship in the market economy (arbitrage) lead to economic coordination, or the more efficient allocation of resources in the economy. Stated differently, he says that entrepreneurship in the market economy initiates a tendency toward economic equilibrium.

Part 1 of this essay describes Kirzner's idea of the entrepreneurial element in individual decision-making. Part 2 describes his method of building the image of the pure entrepreneur and the pure entrepreneur economy. Part 3 describes his notion of arbitrage. Part 4 presents Kirzner's notion that there is a parallel between the outcome of entrepreneurship in individual action and the tendency towards economic equilibrium.

1. ENTREPRENEURSHIP IN A CRUSOE SITUATION

The starting point for understanding Kirzner's definition of entrepreneurship is the isolated actor.

This part describes this definition.

Spontaneous Learning

Kirzner's idea of entrepreneurship is based on what he calls *spontaneous learning*.^[1] The simplest situation in which spontaneous learning can occur is a Crusoe situation. Thus, Kirzner begins by describing it under those conditions. He says:

...A piece of knowledge about boat-building, about whose correctness Crusoe has no doubts at all, will not be seen as a hunch and will be valued according to Menger's Law. It may be said that Crusoe is well aware that he possesses this kind of information; he will deploy and value it in the same way as he may be imagined to deploy and value other resources he believes are definitely at his disposal. But concerning Crusoe's hunches and his visions in the face of a changing, uncertain environment, it cannot be said at all that Crusoe knows he has a hunch or a vision of the future. He does not act by deliberately utilizing his hunch about the future; instead, he finds that his actions reflect his hunches...In other words, it turns out, the essence of entrepreneurial vision, and what sets it apart from knowledge as a resource, is reflected in Crusoe's lack of self-consciousness concerning it...Crusoe may...gradually come to be aware of his vision. When he does, that vision ceases to be entrepreneurial and comes to be a resource. Moreover, Crusoe's *realization* that he possesses this definite information resource may itself be entrepreneurial. As soon as he 'knows' that he possesses an item of knowledge, *that* item ceases to correspond to entrepreneurial vision; instead, as with all resources, it is Crusoe's belief that he has the resources at his disposal that may now constitute his entrepreneurial hunch" (1979: 168-169).

As Crusoe gradually becomes aware of his so-called entrepreneurial vision, he learns. He cannot be said to have planned his learning. Thus, it is subconscious. Subconscious learning is synonymous with the transformation of a previously unrecognized "entrepreneurial vision" (the subconscious hunch) into a recognized contributor to satisfaction. It is also synonymous with spontaneous learning.

Note the way that Kirzner uses the term "belief" in this last sentence of the quoted passage. When he says that Crusoe's belief may constitute an entrepreneurial hunch, he is not referring to a *conscious* belief. If Crusoe acted on the basis of a conscious belief, he would in essence be betting that his belief was correct. His action would be a deliberate choice. However, as Kirzner points out earlier in the quotation, "it cannot be said at all that Crusoe knows he has a hunch or a vision of the future. He does not act by deliberately utilizing his hunch about the future; instead, he finds that his actions reflect his hunches..." Thus the belief is subconscious. A belief in this context is synonymous with a subconscious hunch.

Alertness

Kirzner calls the state of mind that enables spontaneous learning to occur *alertness*. Just as learning is spontaneous, so is alertness. It cannot be produced or improved upon. This state of mind is part of human nature, by definition.^[2]

Individuals differ in their alertness. If two individuals have identical boat-building experiences, one may learn while the other does not (1979: 170).

Transformation of Spontaneous Learning into Conscious Knowledge

After it is recognized, a hunch is no longer subconscious. Accordingly, it is also no longer an aspect of Kirzner's entrepreneurship. It becomes, in Kirzner's terminology, a resource. The individual takes it into account in his decision-making. When a person realizes that following a previously subconscious hunch is a means of increasing his satisfaction, he simultaneously discovers that he possesses a resource. Thus, "entrepreneurship is a discovery process," albeit a subconscious one.

A similar argument would presumably apply to the realization that a previously subconscious hunch had caused a decline in satisfaction. In this event, the individual would discover a resource in that he would realize that a decision not to act on the hunch would raise his satisfaction.

Motivation for Subconscious Learning

In spite of the fact that spontaneous learning is a subconscious process, Kirzner says that it is encouraged by the possibility of gain. He says:

[I]f we know anything at all about the process of spontaneous discovery of information, it is that this process is somehow altogether more rapid when the relevant information will be of benefit to the potential discoverer (1979: 149).

He cannot mean by this that Crusoe is consciously motivated to spontaneously discover knowledge. Instead, he must have in mind some kind of subconscious motivation, or instinct.

2. THE PURE ENTREPRENEUR AND THE PURE ENTREPRENEUR ECONOMY

Kirzner introduces the notion of the pure entrepreneur by saying that there are two distinct ways in which this notion enters the analysis of the market process: (1) by means of contrast with Robbinsian economizers, and (2) through the alertness, as defined above. The concept of the pure entrepreneur refers to both of these. The pure entrepreneur is "a market participant whose decisions are *entirely incapable* of being subsumed under the category of Robbinsian economizing." And the pure entrepreneur is "a decision-maker whose *entire* role arises out of his alertness to hitherto unnoticed opportunities" (Kirzner 1979: 38-9).

He combines these characteristics to describe the pure entrepreneur and the pure entrepreneur economy. However, there is a good reason to keep them separate. The idea of separating the

entrepreneurial element from economizing has a history in economic theory that appears to begin with the notion that capital consists of the appraised value of the resources.[3] This notion conjures up an image of profit-anticipating entrepreneurs rather than Robbinsian economizers.[4] Keynes apparently also used the notion of a pure entrepreneur economy.[5] It nevertheless seems true that no one suggested the procedure of contrast until Mises and also that no one set it out as clearly as Kirzner.[6] Thus, in this subsection, we shall follow Kirzner in building an image of the pure entrepreneur whose "decisions are *entirely incapable* of being subsumed under the category of Robbinsian economizing." However, unlike Kirzner, we shall initially assume that we have not yet identified the precise characteristics of the entrepreneur.[7] Thus, we explore the procedure that Kirzner uses to conceive of pure entrepreneurship in relation to Robbinsian economizers.

In introducing the notion of the pure entrepreneur, Kirzner makes two references to Mises. First, he quotes Mises as follows:

Economics, in speaking of entrepreneurs, has in view not men, but a definite function. This function is inherent in every action...In embodying this function in an imaginary figure, we resort to a methodological makeshift (Mises 1966: 252-3; Kirzner 1973: 39).

Second, he refers to broadening "our theoretical vision of the individual decision-maker from a 'mechanical' Robbinsian economizer to Mises's *homo agens* (*ibid.*: 72).

For the moment, let us not consider the characteristics that Mises assigns to the *homo agens*. This will allow us to present the procedure that Kirzner has in mind for broadening our theoretical vision without dealing with the issue of whether the procedure is being used to elucidate alertness or some other set of characteristics. Suppose that we wanted to elucidate the *homo agens* element of decision making. Then we could contrast an image of Crusoe as an economizer with Crusoe as *homo agens*. Similarly, if we wanted to elucidate the *homo agens* element that is present in the market, we could contrast an image of an economy containing only Robbinsian maximizers with an image of an economy that also contains individuals who have the characteristics of *homo agens*. This is precisely what Kirzner does.

He employs an analytical device that concentrates "all entrepreneurship into the role of the hypothetical pure entrepreneurs" (*ibid.*: 72). Conceiving of entrepreneurs by means of this device, "it becomes possible to speak of a market in which all other market participants are pure Robbinsian economizers, without any element of entrepreneurship whatsoever" (*ibid.*: 41). "We may in this way continue to envisage a market in which consumers and resource owners are strictly Robbinsian economizers, exclusively price-takers, and shift the entire burden of price changes and changes in methods of production and of output quality and quantity upon the pure entrepreneurs" (*ibid.*: 72; see also Kirzner 1967: 796-797). "The activity of these pure entrepreneurs can then explain how prices and input and output quantities and qualities change" (*ibid.*: 42). It is true that this image of Robbinsian economizers and pure entrepreneurs "fails as a satisfying explanation of the real world..." However, "it is analytically expedient to treat the human being as if he represented two entirely separate decision-makers, one a passive economizer, the other a pure entrepreneur (*ibid.*: 43). When all the pure entrepreneurs and Robbinsian maximizers are taken together, the result is what the author has called the pure entrepreneur economy (Gunning 1997).

3. ALERTNESS AND ARBITRAGE

So far we have treated the pure entrepreneur as an entity without specific characteristics. Now we turn to the characteristics that Kirzner assigns. These correspond to his interpretation of Mises's *homo agens*, as mentioned earlier. The first characteristic is alertness, as pointed out in part 2.

According to Kirzner, the "crucial question [in the task of a theory of the market] concerns the nature of the forces that bring about changes in the buying, selling, producing, and consuming decisions that make up the market" (Kirzner 1973: 70). These forces, he says, consist of learning from mistakes. To

explain how yesterday's market experiences can account for changes in plans that might generate alterations in prices, in outputs, or in the uses of inputs...it is necessary to introduce the insight that men...learn from their experiences in the market. It is necessary to postulate that out of the mistakes which led market participants to choose less-than-optimal courses of action yesterday, they can be expected to develop systematic changes in expectations concerning plans (*ibid.*: 71).

The learning he has in mind is subconscious, as in the Crusoe situation. This means that we must be careful in our interpretations. Consider the phrase "systematic changes in expectations concerning plans." These changes are not consciously chosen. Kirzner is not referring here to market participants who, each motivated by his personally projected gain from trade, deliberately discovers the others' willingness to trade. He is referring to a subconscious process. The expectations that traders have of others' plans change *subconsciously*. Traders are subconsciously alert to the changes.

In short, the pure entrepreneur first subconsciously discovers what he regards as an opportunity to earn money by buying and selling (or by buying resources, producing a good, and selling it). Then he finances his venture by borrowing money from a *capitalist*. The entrepreneur uses the funds for his entrepreneurial venture, then he pays back the capitalist, including "interest," and keeps the "pure entrepreneurial profit" (*ibid.*: 49-50).

Although the capitalist lender may play a role in every entrepreneurial venture, the role of the pure entrepreneur is separate from that of the capitalist. The capitalist as such does not exhibit alertness (*ibid.*: 47-9 and 1979: 87, 96-8). Also, although a pure entrepreneur may have to produce goods in order to obtain his profit, production is also not a necessary part of pure entrepreneurship. Finally, although all behavior in the market takes time, we can build an image of entrepreneurship narrowing price discrepancies in a timeless world. It follows that time is not a necessary part of pure entrepreneurship. And it seems like a good descriptive label for the behavior performed by the pure entrepreneur is arbitrage (Kirzner 1973: 48). Thus the defining characteristic of entrepreneurship in the market economy is arbitrage.

Differences Among Individuals

Individuals in a market differ in their alertness (Kirzner 1979: 170). For example, if two individuals buy and sell on the basis of subconscious hunches, the first may be more correct, in the eyes of superior insight, than the second. The money earned by the first will correspondingly be greater. Similarly, if two individuals buy and sell on the basis of the same subconscious hunches, one may come to subconsciously realize that the hunch resulted in gains while the other remains unaware of his hunch's contribution to his earnings. Learning occurs in the first instance only.

Learning as Discovery and Transformation

Learning in a market, according to Kirzner, consists of a transformation of a non-means into a means -- at least to the individual who experiences it. Imagine that an individual subconsciously learns that his previous subconscious hunch enabled him to gain in a market. Later, he experiences a similar choice situation. At the later time, his knowledge, not his hunch, would enable him to make a correct choice. Looking at events in retrospect, the individual can be said to have discovered that he possesses a means of satisfying his wants of which he was previously unaware. At the time that the hunch is discovered, it gets transformed into a resource -- knowledge. Thus alertness, subconscious learning, and entrepreneurship are "discovery processes."

Encouragement of Subconscious Learning in a Market

Subconscious learning in the market can be encouraged in two ways, according to Kirzner. First, it can be encouraged by others' advertising:

If the advertiser projects his message to the potential consumer in color, or with comic illustration, or accompanied by a certain piece of music, surely this is because the advertiser knows not merely how to lower the cost to the consumer of learning his message, but how to encourage spontaneous learning by the consumer with no deliberate search at all (1979: 149).

Second, subconscious learning can be encouraged by institutional arrangements. Institutional arrangements determine the gains that are available to different individuals when they subconsciously learn. Because subconscious learning in some individuals is superior to that in others, it is important that those who are superior receive higher gains.

It would be a mistake to imagine...that spontaneous discovery is a wholly unexplainable process...[I]t is clear that opportunities for social improvement will tend to be exploited most fruitfully if institutional arrangements can be patterned so as to translate such opportunities into opportunities that will be encountered by those whose entrepreneurial alertness is the most acute, the most sensitive, the most accurate...Entrepreneurial alertness, that is, is sensitive not so much to information per se as to information that can be deployed to one's advantage (1979: 149).

The institutional arrangements that Kirzner has in mind are those of "the market." In other words, he argues that private property rights, free enterprise, and the use of money in calculation provide an environment in which subconscious learning will occur. This institutional setting leads people

to interact in such a ways that otherwise “unnoticed opportunities for mutually profitable exchange among individuals” are translated into “forms that tend to excite the interest and alertness of those most likely to notice what can be spontaneously learned” (*ibid.*: 150).

Kirzner notes a characteristic of alertness in the market that is not present in the Crusoe situation. He says:

It is true that "alertness," too, may be hired; but one who hires an employee alert to the possibilities of discovering knowledge has himself displayed alertness of still a higher order (1973: 68).

Thus, whereas Crusoe is unaware of the alertness that exists in his isolated situation, one individual in the market situation may recognize the alertness possessed by another. Yet the one who recognizes the other's alertness is at first unaware of her own alertness. That is, she is unaware of the alertness that enabled her to recognize the other's alertness. Later, however, she may come to know the other's alertness at which point both her alertness and the other's alertness become resources.

4. ENTREPRENEURSHIP AS EQUILIBRATING

From a purely logical, or definitional, standpoint Kirzner's notion of entrepreneurship as equilibrating combines three ideas. The first is that subconscious learning is equilibrating to the isolated actor. The second is that subconscious learning about arbitrage opportunities is equilibrating in markets. The third is that subconscious learning would lead to a general equilibrium if there were no changes in the non-entrepreneurial determinants of demand and supply. We discuss each in turn.

The Logic of Equilibrating Entrepreneurship

Subconscious Learning as Equilibrating

Kirzner expresses the view that subconscious learning is equilibrating in a Crusoe situation in the following way:

The tendency of purposeful human beings to become aware of available opportunities [by means of subconscious learning] tends, with greater or lesser rapidity, to eliminate misallocation, error, violations of Menger's Law, and the occurrence of possibilities for pure Crusoean profit (Kirzner 1979: 172).

Kirzner says that a misallocation of resources means decisions that are wrong, "in the Robbinsian sense...from the point of view of superior entrepreneurial insight" (*ibid.*: 171-172).

It is essential to understand precisely what Kirzner means. He implicitly assumes that one can adopt two viewpoints of Crusoe. The first is Crusoe's own. As Crusoe views his situation, he is

aware of a number of means of satisfying his wants but unaware of others. The second is that which corresponds to "superior entrepreneurial insight." From this viewpoint, Crusoe misallocates his resources when he is not currently aware of some ends or means that are destined to be learned by him subconsciously.

The profit possibilities that Kirzner says exist in a Crusoe situation are determined by focusing on the difference between what Kirzner assumes to be known by Crusoe himself about his subconscious hunches and what he assumes to be known about Crusoe's hunches by one who has superior insight. As Crusoe behaves, he learns unexpectedly. In so doing, he gains the "profit" of which superior insight was already aware. Crusoe himself is unaware of the profit possibilities.

He says that subconscious learning is equilibrating in the following sense. If Crusoe were to learn about all his subconscious hunches, none of his decisions would be made on the basis of them. He would become an economizer. The perspective of superior insight would reveal no additional subconscious learning possibilities.

As mentioned, for the Crusoe situation, the subconscious hunches lead to Crusoean profit and equilibrium simultaneously. Crusoe's alertness enables him to acquire knowledge that ultimately makes him better off than he otherwise would have been. In the example described earlier, it does this by improving his knowledge of boat building. Thus Kirzner finds correspondence between Crusoean equilibrium and Crusoe's well being, as judged by superior insight.

Arbitrage Actions as Equilibrating

In the market economy, what Kirzner calls the "entrepreneurial element in individual decision-making" impacts through arbitrage. Like the isolated individual, the arbitrager behaves according to subconscious hunches. He observes prices and follows his subconscious hunch to arrange an exchange between a seller who attaches a low dollar value and a buyer who attaches a higher dollar value. Given that his hunch is correct, the result is entrepreneurial or market "profit." [8] Economists who are accustomed to identifying entrepreneurship with conscious actions must be careful in order to avoid misinterpreting Kirzner on this point. Like the case of pure Crusoean opportunities, arbitrage profit cannot be defined unless one adopts the viewpoint of "superior entrepreneurial insight." This insight must conjure up a general equilibrium in order to fully comprehend profit.

Arbitrage actions are equilibrating in the sense that they narrow what would otherwise be wider price differences. An arbitrage action causes a mutually advantageous exchange that would otherwise not be made. If no arbitrage possibilities existed -- from the standpoint of superior entrepreneurship -- equilibrium would already have been achieved.

General Equilibrium Due to Subconscious Arbitrage

Kirzner says that just as there is a tendency for arbitrage to lead to equilibrium in a particular market, there is also a tendency for it to lead to a optimum general equilibrium, or equilibrium in

all markets. An equilibrium state is one in which no further learning resulting from following subconscious hunches is possible. All the knowledge of wants, abilities and knowledge that the economist assumes to be relevant from the standpoint of superior insight has been acquired by the various individuals.[9]

It seems reasonable to equate equilibrium with the conscious realization that previously subconscious hunches that prompted specific arbitrage activity were not only correct but are, in equilibrium, recognized by individuals as having been correct. In addition, there can be no further subconscious hunches. Of course, no such situation could ever arise in reality.

Finally, just as Crusoe following his subconscious hunches led to an increase in Crusoe's well being, so does the pure entrepreneurs following subconscious hunches increase the well being of individuals in the market. In the image of the pure entrepreneur economy, the welfare of the passive, economizing consumers and resource-suppliers increases.

Why Study Equilibrium?

Why is it important to regard entrepreneurship as equilibrating? Kirzner really gives two answers. First, equilibrium corresponds to greater coordination. This appears at first to be a normative answer. But he does not stress this and indeed seems to try very hard to avoid equating greater coordination with welfare. Second, he says that we can actually observe something akin to equilibrium in those societies where the conditions of the market economy prevail. Specifically, we observe a kind of coordination that is the result of human action but not of design, a spontaneous order.[10] With this observation in the back of our minds, we set out to explain it. In other words, we set out to describe the tendency toward equilibrium. Some writers would call this an empirical basis for studying a tendency toward equilibrium. Kirzner's pragmatic argument is stated most clearly in his introduction to a collection of his essays. He begins by adopting what he calls Professor Garrison's position that he and other modern Austrian economists occupy a "middle ground" between what he calls mainstream neoclassical economics and radical subjectivism (Kirzner 1992: 1-2). He points out that the radical subjectivists have criticized middle-ground Austrian preoccupation with equilibrium (i.e., the tendency toward) on the grounds that the future is unknowable. In opposition to this, Kirzner maintains that "economic science has always proceeded from the important empirical circumstance of economic order...That the market works is perhaps the most significant lesson of modern history...The problem which has always worried theorists is how, without deliberate co-ordination, can markets *possibly* work" (*ibid.*: 35). The danger of radical subjectivism, Kirzner says, is that one may come to "*reject* the central lesson of economic reasoning, the understanding of and appreciation for the market co-ordinating process." If one does this, he may go on to commit the "fallacy of seeking social efficiency *without* the market" (*ibid.*: 36). The problem faced by economic science is thus one of showing how separate individuals produce the rather vague image of market order.

1. [A]s time flows on, men are subject to a spontaneously increasing awareness of information hitherto veiled in ignorance."(Kirzner 1979: 146)

2. In his 1979 book, Kirzner seems to claim a priori validity for his concepts of alertness and subconscious learning.(Kirzner 1979: 130-1 and 152)

3. This idea is most clearly represented in H. Davenport's notion of "loan fund capital" (Davenport 1914: chapter 18)

4. The early theory of J. B. Clark of capital as a fund was the starting point. The later theory of H. Davenport, which he called the loan fund theory of capital, regarded each actor as an entrepreneur in that each actor appraised what he regarded as his resources with an eye towards either exchanging those resources in markets or using them himself. The loan fund was the sum of these separate appraisals of every individual acting in the role of the entrepreneur. (Davenport 1914: chapter 13)

5. See Torr, 1980.

6. Mises makes a number of suggestive remarks about how to use the evenly rotating economy containing automatons. The most extensive discussion is in Mises 1966: 246-55. Mises does not discuss Robbinsian economizers directly. However, (1) he does conceive of elucidating entrepreneurship by means of making a contrast with the evenly rotating economy (*ibid.*: 248) and (2) the evenly rotating economy contains consumer-savers, and resource suppliers that are automatons. This suggests that he had in mind a contrast with an imaginary economy comprised of automatons.

7. In earlier writings on the history of entrepreneurship, I failed to identify Kirzner as playing a major role in developing the method of isolating entrepreneurship from other human behavior which is not distinctly human.(Gunning 1990; 1992; 1997) Indeed, I implied that this method evolved mainly as the result of my efforts to understand Mises's chapter 14 of *Human Action*. I now see that I was probably wrong in this. Indeed, since I read Kirzner's *Competition and Entrepreneurship* before I read Mises's *Human Action*, it is possible that Kirzner's discussion prepared me for my rather special interpretation of Mises's method of imaginary constructions. On the other hand, the context of Kirzner's presentation is sufficiently different from that of Mises that I cannot be certain of this.

8. It is important to distinguish this idea of profit from the usual idea of profit in professional economics. Professional economists often say that the anticipation of profit motivates individuals to act entrepreneurially. They mean that in deciding how to act, a subject builds an image of a future in which he has earned a greater amount of income than he could have earned from some alternative. When he deliberately chooses what he thinks is the higher-yielding alternative, his choice is said to have been motivated by the anticipation of profit. Kirzner has no such deliberate choice in mind. In Kirzner's image, profit cannot be anticipated in this way because it is the result of following a subconscious hunch. It is worth pointing out that this profit is not associated with luck either. Kirzner points out that the term profit is often used to refer to windfalls due to luck. However, the distinguishing characteristic of such cases is precisely that even superior insight could not have predicted the income. The profit that Kirzner has in mind does not include such windfalls (Kirzner 1979: 179-80).

9. Kirzner (1979: 110) points out that what he calls the "entrepreneurial element in the individual decision...becomes apparent" from [is derived from?] the idea that equilibrium assumes perfect knowledge.

10. See Hayek 1967: chapter 6.

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