Israel M. Kirzner and the Entrepreneurial Market Process

An Appreciation

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Israel M. Kirzner, more than any other economist in the post–World War II era, has revived our understanding of the systemic role of the entrepreneur as the driving force of open and competitive markets, understood as a process of discovery, error correction, and learning. During his prolific career, his contributions to the theory of capital and interest, economic methodology, history of economic thought, and, especially, the economics and ethics of entrepreneurship, have been integral to reviving the Austrian school of economics in the tradition of Carl Menger, Eugen von Böhm-Bawerk, Friedrich Wieser, Ludwig von Mises, and F. A. Hayek. The implications of his work have also been crucial in reframing our understanding of the roles of antitrust (Kirzner 1997), advertising (Kirzner 1972), and distributive justice (Kirzner 1988, [1989] 2016, 2019) in the market process.

Indeed, Kirzner's work has been recognized and applied not only in economic theory but also in the study of entrepreneurship, business economics, and economic management, for which he was awarded the International Award for Entrepreneurship and Small Business Research in 2006 (see Douhan, Eliasson, and Henrekson 2007).

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The Independent Review, v. 28, n. 2, Fall 2023, ISSN 1086–1653, Copyright © 2023, pp. 1–12.

True to his own understanding of his work, Kirzner was puzzled at being so honored, given that his scholarship explains that the source of economic development can be found in the entrepreneurial market process but that this research *cannot* explain the secrets of successful entrepreneurship itself (Kirzner 2009, 145–46). Upon being awarded the International Award, Kirzner made a point of acknowledging the influence of Mises on his scholarship: "I have always emphasized that my own contribution is simply an expansion and deepening of insights articulated by my teacher, Ludwig von Mises" (2009, 146). However, Kirzner has done more than just expand and deepen the insights of Mises. The hallmark of Kirzner's scholarship has been to take his inspiration from Mises and develop his own unique appreciation of the entrepreneurial market process, not for the purpose of illustrating where mainstream economic theory of his time had gone wrong per se, but to explain why its focus on equilibrium states painted an *incomplete* picture of the market process.

In spite of a growing awareness of the importance of the role of the entrepreneur in economic theory, the importance of Kirznerian entrepreneurship to understanding the market process remains relatively neglected. To the extent that entrepreneurial explanations enter into the dynamics of the market process, the predominant account is one that was first expounded by Joseph Schumpeter ([1911] 1934). Before providing an overview of the importance of Kirzner's scholarship, I will first outline the intellectual context within which Kirzner entered the academic profession and explain how Kirzner's contributions remain underappreciated. In doing so, I hope to establish the significance of Kirzner's analysis to understanding the entrepreneurial market process as well as its continued relevance.

According to Kirzner, the year 1954 marked a professional turning point in his life. Upon completing his undergraduate studies at Brooklyn College, Kirzner enrolled in the MBA program at New York University (NYU), initially aiming to pursue a career in accounting. However, searching for courses to take in fulfilling the requirements for his MBA, which he completed in 1955, he enrolled in a course with Ludwig von Mises. It was taking Mises's course that led Kirzner to decide to pursue a PhD in economics, completed in 1957 under the supervision of Mises. Upon earning his PhD, Kirzner joined the faculty of NYU, where he spent the entirety of his academic career.

It was also during this time that, in spite of the work of classical economists and, later, early neoclassicals, such as Frank Knight and Joseph Schumpeter, who had explicated the dynamic function of the entrepreneur in the marketplace, the role of the entrepreneur had been all but rendered into obscurity by the mid–twentieth century. This was a result of the preoccupation with analyzing markets as an equilibrium state of affairs rather than processes of equilibration. One way in which to situate the importance of Kirzner's seminal contributions is in terms stated by his student Don Lavoie (1991, 39): "Mainstream economics, according to Kirzner, is not so much wrong as simply incomplete." Building on this point, the work of Kirzner is a critical juncture in the history of economic thought, first by rendering explicit what had been implicit in classical economics, and then by reinserting what had been left behind as a consequence of the marginal revolution: the entrepreneurial element of human action as the basis for equilibrating market processes in an open-ended world of uncertainty.

From Kirzner's standpoint, the market process, as understood by classical political economists, was not so much flawed as it was simply incomplete in its explication of entrepreneurship and the role that pure entrepreneurial profits play in driving the market as a competitive process of discovery. Kirzner elaborated as follows:

> The volume of *pure* profit won by entrepreneurs surely refers to only a small fraction of capitalist "profits" in the broad sense of the word used by the classical economists (and especially by Marx). It is no accident, it could be conjectured, that pure profit did not loom more importantly in the classic discussions of capitalist justice; the phenomenon was simply not important enough. (Kirzner [1989] 2016, 109, emphasis in original)[1]

This early neoclassical period, pioneered by William Stanley Jevons, Carl Menger, and Léon Walras, was distinct from the preceding period of classical political economy because of a gradual receding of institutional analysis into the background of economic theory. What would emerge in the foreground of economic analysis during this period was *the study of price formation and adjustment* based on subjective marginal utility. However, the preoccupation with proving the existence, stability, and uniqueness of competitive equilibrium in markets, as had been pursued by Nobel laureate Kenneth Arrow[2] (as well as Gerard Debreu and Frank Hahn), would lead him to conclude that economic theory has *no theory of price adjustment*. In a paper ironically titled "Toward a Theory of Price Adjustment," Arrow argued the following:

> Under conditions of disequilibrium, there is no reason that there should be a single market price, and we may very well expect that each firm will charge a different price. . . . The law that there is only one price on a competitive market (Jevons' Law of Indifference) is derived on the basis of profit- or utility-maximizing behavior on the part of both sides of the market; but there is no reason for such behavior to lead to unique price except in equilibrium, or possibly under conditions of perfect knowledge. (Arrow 1959, 46)

With this intellectual background in mind, the evolution of Kirzner's scholarship can be understood as a consistent explication of the entrepreneurial role in the market process, as well as its normative implications. Kirzner's own understanding of entrepreneurship began with his doctoral dissertation, a topic recommended to him

1. See also Kirzner's "Classical Economics and the Entrepreneurial Role" in *Perception, Opportunity, and Profit* (Kirzner 1979, 37–52).

2. See, for example, Arrow and Debreu (1954).

by Mises. Completed in 1957, it was later published in 1960 as Kirzner's first book, *The Economic Point of View*. Kirzner's argument was that the transformation of economic theory can be understood as evolving from a science defined as studying the accumulation of *material wealth* to a science broadened to encompass the study of *human action*. By tracing out that evolution from Adam Smith onward, Kirzner sowed the seeds for his refinement and articulation of the entrepreneurial element of human action: "The 'propensity to truck' must be understood as the faculty that men possess of recognizing situations in which the device of exchange, understood in this sense, would prove profitable" (Kirzner [1960] 2009, 83).

Despite Kirzner's own understanding of the intellectual trajectory toward which economic science had evolved—as he had learned from Mises—by the 1960s, mainstream economic theory had been immersed in a preoccupation with analyzing the conditions of a perfectly competitive market. Such an analytical focus came at the expense of understanding the process that creates tendencies toward a perfectly competitive outcome, and a process that entails the mutual coordination and adjustment of buyers' and sellers' plans. Kirzner's second book (and his only textbook), *Market Theory and the Price System* (1963), was written to fill the gap that had opened not only in mainstream economic theory but also in its pedagogy. By reducing the attention paid to perfect competition, Kirzner redirected economic analysis away from assessing the inefficiency of real-world markets versus the textbook ideal of perfect competition. Instead, the efficiency of market processes, according to Kirzner, should be assessed in terms of communicating errors to entrepreneurs in the form of current losses, which create future profit opportunities that are realized by correcting inefficiencies in the misallocation of resources toward their most valued consumer uses.

Throughout the 1960s and early 1970s, Kirzner continued to deepen and refine his account of the entrepreneurial market process through a series of papers,[3] culminating in his most well-known book, *Competition and Entrepreneurship* (1973). The impact of that book, along with *The Economic Point of View* ([1960] 2009) and *An Essay on Capital* (1966), have been recognized by the History of Economics Society (HES), which named Kirzner a Distinguished Fellow in 2018.[4] According to Kirzner, entrepreneurship refers not to a particular talent that is unique to a subset of individuals in society. Rather, it is the central element of *all* human decision making. The entrepreneur acts as an agent of change, discovery, and error correction through his or her "alertness" to pure profit opportunities. As Kirzner states: "It is this entrepreneurial element that is responsible for our understanding of human action as active, creative, and human rather than as passive, automatic, and mechanical. Once the entrepreneurial element in human action is perceived, one can no longer interpret the decision as merely calculative—capable in principle of being yielded

3. See in particular Kirzner (1967b), as well as Kirzner (1967a, 1971).

4. History of Economics Society, "Distinguished Fellow," at https://historyofeconomics.org/awards-and-honors/distinguished-fellow/.

by mechanical manipulation of the 'data' or already *completely implied* in these data" (Kirzner 1973, 35, emphasis in original).

The best way to articulate Kirzner's unique contribution to the theory of entrepreneurship in the market process is by juxtaposing Kirzner's theory of the entrepreneur with that developed earlier by Joseph Schumpeter in the pre–World War II era (Schumpeter [1911] 1934, [1942] 1947; see also Rothbard 1987). According to the Schumpeterian account of entrepreneurship, the analytical point of departure for understanding the role of the entrepreneur is to begin in a state of equilibrium, in which all profit opportunities have been exhausted. Economic development, according to Schumpeter, "is a distinct phenomenon, entirely foreign to what may be observed in . . . the tendency towards equilibrium" ([1911] 1934, 64). Therefore, the Schumpeterian entrepreneur is an innovator who has a *disequilibrating* effect on the market process, namely, by *creating* profit opportunities through technological innovation and therefore disrupting a preexisting state of equilibrium. Thus, entrepreneurship results in what Schumpeter referred to as "creative destruction" ([1942] 1947, 83). The Kirznerian account of entrepreneurship, however, begins in a world of disequilibrium as its starting point, implying that a particular state of affairs at any moment of time and place is "nothing but a seething mass of unexploited maladjustments crying out for correction" (Kirzner 1979, 119). When he or she perceives such inefficiency from unrealized gains from trade, the Kirznerian entrepreneur captures pure profit and exhausts the available gains from trade by redirecting resources from less valued consumer uses to more valued consumer uses. In effect, the Kirznerian entrepreneur is an arbitrageur who *discovers* previously unnoticed profit opportunities by purchasing resources, allocated toward a less valued consumer use at a lower price, and reselling them in a higher-valued consumer use at a higher price. Thus, the Kirznerian entrepreneur has an *equilibrating* effect on the market process by creating a tendency toward one price across all markets for a particular productive resource, consumer good, or service.

One particular avenue of research in which Kirzner's account remains relatively underappreciated has been in the study of economic development. Much of the resurgence in attributing economic development to the relative allocation of entrepreneurship toward productive or unproductive activities can be traced back to William Baumol's seminal paper "Entrepreneurship: Productive, Unproductive, and Destructive" (1990).[5] Baumol's central claim is that the relative allocation of entrepreneurship between productive, unproductive, and destructive activities "depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail" (Baumol 1990, 894). Thus, entrepreneurship is ubiquitous, but its manifestation is institutionally contingent (Boettke and Coyne 2003). Indeed, an entire literature on entrepreneurship has taken inspiration from, and built upon, Baumol's

5. Baumol also was the 2003 recipient of the International Award for Entrepreneurship and Small Business Research.

Schumpeterian framework (see for example Li, Feng, and Jiang 2006; Henrekson and Sanandaji 2012; Aeeni et al. 2019). By his own admission, however, Baumol concluded that the Schumpeterian entrepreneur provides an incomplete basis for explaining, in the words of Eric Jones, "the European Miracle" ([1981] 2003). Given that, for most of its history, Europe was both a cultural and technological backwater compared with China (see Rosenberg and Birdzell 1986, 87; Jones [1981] 2003, 6), this empirical fact presents a puzzle that cannot be explained solely by a Schumpeterian account of entrepreneurship. This was admitted by Baumol, who provided a *Kirznerian* answer as to why this is the case:

> To derive more substantive results from an analysis of the allocation of entrepreneurial resources, it is necessary to expand Schumpeter's list, whose main deficiency seems to be that it does not go far enough. For example, it does not explicitly encompass innovative acts of technology transfer that take advantage of opportunities to introduce already-available technology (usually with some modification to adapt it to local conditions) to geographic locales whose suitability for the purpose had previously gone unrecognized or at least unused. (Baumol 1990, 897)

The unintended, and unexpected, economic transition of the West from subsistence to exchange was fundamentally predicated on *creative arbitrage* (see Candela, Jacobsen, and Reeves 2022), namely (as Baumol put it), innovative acts of technology transfer by arbitraging it from one geographic location (with a less valued use) to another geographic location (with a more valued use). These creative acts of arbitrage were facilitated by Kirznerian productive entrepreneurship, which had been uniquely adapted to the commercial demands of European commerce and facilitated by political fragmentation and interjurisdictional competition.

Moreover, the importance *and* relative underappreciation of Kirzner's contributions to economic theory can also be understood in terms of their public policy implications. For example, Harold Demsetz's work, like that of Kirzner, provided a fundamental challenge to the prevailing orthodoxy of textbook perfect competition and the apparent prevalence of "market failures" associated with deviations from this ideal model to which the market ought to conform. Those perceived imperfections include the allegation that the markets are prone to create monopoly power, externalities, macroeconomic instability, underprovision of public goods, and inequality in the distribution of income. Nevertheless, Demsetz argued, while not denying the renewed importance of the entrepreneur to economic theory, that Kirzner had not accounted for anything substantially different from what had already been accounted for in the standard neoclassical market model. Because "alertness itself is a form of investment under conditions of uncertainty," it "is in principle indistinguishable from the analysis of such investment problems" (Demsetz 1983a, 279).

Whether Demsetz was indeed correct in claiming such redundancy in Kirzner's analysis can best be illustrated by its public policy implications. For example, the failure to distinguish entrepreneurship from the ownership of capital only reinforces the particular argument that regulation is justified for the purpose of correcting a "market failure" associated with monopoly power based on economies of scale, which are regarded as a barrier to entry. Such an argument has been the basis for recent calls to regulate digital platform economies. However, the role of limited liability, which may be regarded as the source of corporate power, is, according to Demsetz, the very basis for its *discipline and erosion*. This is because "limited liability considerably reduces the cost of exchanging shares by making it unnecessary for a purchaser of shares to examine in great detail the liabilities of the corporation and the assets of other shareholders" (Demsetz 1967, 359). Although he acknowledged this disciplinary role of limited liability,[6] what Demsetz's assertion overlooks is that the *institutional* importance of limited liability in disciplining monopoly power is *fundamentally* predicated on there being an analytical distinction between entrepreneurship and capital ownership. Entrepreneurial profits, according to Kirzner, are not discovered by virtue of the fact that firm owners are owners of capital. Indeed, capital is required to later realize an entrepreneurial opportunity, but the ownership of capital is a *consequence* of having first discovered that a profit opportunity exists (Kirzner 1979, 104).

This being said, Kirzner never asserted that markets are perfect, nor that the presence of market imperfections require government regulation. For Kirzner, market "imperfections" that deviate from the textbook ideal of perfectly competitive equilibrium do not necessarily prevent the price system from coordinating economic activity but in fact *depend on it* because such deviations from the ideal represent entrepreneurial profit opportunities that fuel tendencies toward equilibrium. The relevant inquiry, then, is not whether government regulation is necessary to correct for market imperfections but how different sets of policies incentivize the discovery of particular types of profit opportunities by entrepreneurs.

The key to understanding why the correction of market imperfections hinges on the entrepreneurial market process, rather than government regulation, is the context-specific nature of profits *and* losses, as explained in Kirzner's "The Perils of Regulation" ([1978] 1985). Within an institutional environment of private property and freedom of contract under the rule of law, entrepreneurs are residual claimants on the consequences of their decision making, meaning that they bear both the costs *and* benefits of their choices. What is more important, however, is that the very process of rivalrous competition generates knowledge of profit opportunities, which is not available to any single person independently of such rivalrous market competition. Therefore, such economic knowledge is *context-specific* to entrepreneurs

6. For example, see also Demsetz (1983b, 382–83).

competing and therefore is not accessible to individuals operating in nonmarket settings, such as government regulators. However well-motivated and well-intentioned the public sector's regulators may be, they simply cannot correct alleged market imperfections, precisely because they are operating outside a private property context and do not face the discipline of competitive market forces. The implication is that government regulators are precluded from acquiring the knowledge that is necessary for correcting any perceived market failure because it *simply does not exist* for them in the form of entrepreneurial profits *and* losses (Kirzner [1978] 1985, 139–40).

From a Kirznerian perspective, the very notion of "perfect competition" is an oxymoron because a situation in which all relevant information concerning consumer preferences, technology, and resource availability is given would no longer require a market (or government regulation, for that matter) for reallocating resources toward their most valued consumer uses. The "perils of regulation," as Kirzner referred to it, therefore, rest not on any behavioral asymmetry between entrepreneurs and regulators. Both seek to further their own interests in an open-ended world of uncertainty, and neither entrepreneurs nor regulators can foresee future market conditions. Rather, it rests on the fact that when entrepreneurs bear losses for incorrect decision making, such costs are concentrated upon them *and* communicated as future profit opportunities to themselves and other alert entrepreneurs to guide them toward an efficient allocation of resources. The imposition of regulatory constraints by government actors, however, creates what Kirzner referred to as "wholly superfluous discovery processes," which introduce profit opportunities regarded as undesirable in terms of the regulation's intent (Kirzner [1978] 1985, 144–45).

The differences in outcomes in market processes and political processes, therefore, are based on the differences in planning horizons across *time* and the different feedback loops available to entrepreneurs and regulators. Whereas entrepreneurs respond to price signals that emerge through the exchange of anonymous individuals, and to the benefit of individuals they may not know, regulators, precluded from such price signals, can only respond to the knowledge available to them. That is, if regulation introduces undesirable consequences, they can respond in the short run only by introducing new regulation to correct for new profit opportunities that would not have existed if such regulation had not been imposed in the first place. Kirzner argued that "government regulations drastically alter and disturb opportunities for entrepreneurial gain, but they do not eliminate them" ([1978] 1985, 135). Airline regulation under the Civil Aeronautics Board (CAB) from 1938 to 1978 is illustrative of Kirzner's point.[7] In an attempt to regulate price competition among U.S. airlines, the CAB did not reduce nonprice competition among airlines. Rather, CAB regulation unintentionally changed the *manifestation* of entrepreneurial competition between airlines by creating profit opportunities for competition on

7. See also Shughart (2014).

other margins, such as food service and convenient flight schedules. Because the airlines could not compete by offering lower passenger fares, they began offering more sumptuous meals. From the standpoint of the CAB, the airlines' responses had an unanticipated and undesirable effect of creating the famed "sandwich wars" between airlines, after which the CAB began regulating the sizes of sandwiches! Frequent flights between major city pairs meant that just half of the seats were occupied, on average, adding considerably to operating costs and undermining the profitability of the CAB's regulatory regime. Therefore, the question of public policy is not whether a deus ex machina of government intervention must save imperfect markets from failing to live up to the ideal of perfect competition. Rather, if such market imperfections exist, as they always do, the relevant question becomes whether specific public policy measures, such as in the forms of taxes and regulation, will erect barriers to entry that either stifle or redirect entrepreneurship toward counterproductive activities, thus setting the market process up for failure.

Kirzner's understanding of entrepreneurship and how alternative institutional arrangements guide entrepreneurial activities toward productive or unproductive outcomes has important moral implications for the distributive justice of the market process. To the extent that mainstream economic theory frames the market in terms of equilibrium states of affairs, in which the entrepreneur, by definition, has no role, it also fails to account for the economic and moral relevance of discovering pure entrepreneurial profit. Economists have been able to demonstrate, in the best-case scenario, only that the distribution of income through the market mechanism is *not unjust,* meaning it will be unable to justify the discovery of entrepreneurial profits and the pattern of income distribution that emerges from such discovery (Kirzner 2019). At worst, profits earned by capitalists are categorized as "unearned rents" as claimed by Piketty (2014). Thus, any account of the morality of the market process must first begin with the notion that the distribution of income is the outcome of realizing pure entrepreneurial profits. It is not only the final product that is *created* through entrepreneurial discovery, but in the process of such discovery, the economic value of those inputs that are part of the production process are discovered and communicated through the price mechanism. For Kirzner, production is an *ex nihilo creation resulting from entrepreneurial discovery.* "There is nothing automatic or predetermined about the productive efforts put forth in the market economy" (Kirzner [1989] 2016, 16). Rather, each and every transaction in the market process expresses an entrepreneurial element of discovery, implying that all income earned in the market process is *discovered income.*

The profound importance of this insight complements and reinforces other theories of distributive justice based on private property, whether that be a Lockean labor-mixing theory of distributive justice (Locke [1690] 1980) or a Nozickian entitlement theory of distributive justice (Nozick 1974). From Kirzner's standpoint, any account of distributive justice based on a labor-mixing theory with unowned resources, as in the case of Locke, or an entitlement theory of income based on exchange between consenting adults with just holdings of property rights, as in the case of Nozick, must be preceded by how such resources are *discovered* in the first place. Perhaps most important, it also clarifies that Marxist accusations of capitalist injustice have been entirely misdirected because the "'profits' of capitalists which Marxist criticism, for example, saw as exploited away from labor, were not pure profits at all, of course, but a conglomerate of analytically disparate income categories" (Kirzner [1989] 2016, 109), the value of which must be discovered through rivalrous competition between entrepreneurs actively bidding for land, labor, and capital in the first place.

Israel Kirzner is the living embodiment of Hayek's claim that "nobody can be a great economist who is only an economist—and I am even tempted to add that the economist who is only an economist is likely to become a nuisance if not a positive danger" (Hayek [1956] 1967, 123). The power and continued relevance of Kirzner's scholarship is not only evidenced by its theoretical implications for microeconomic theory but also illustrated by its policy relevance. More important, perhaps, centering the case for individual liberty on the entrepreneurial element of human action has normative implications that transcend the distinction between economics and philosophy. To conclude in Kirzner's own words, individual liberty secures the "individual's freedom *to identify for himself what the opportunities are* which he may endeavour to grasp" and hence secures the possibility for productive entrepreneurship and human flourishing (1992, 53, emphasis in original).

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Acknowledgments: I thank Peter Boettke and Christopher Coyne for their feedback and comments on this paper. I am very grateful to the editorial comments and feedback provided by William Shughart II on an earlier draft of this article. Any remaining errors are entirely my own.