

Chapter 5

The Market Process

The market process ... is kept in motion by entrepreneurial activity. Entrepreneurial activity is undertaken to gain profits and therefore, of course, avoid losses ... there are market forces operating upon the price system that tend to remove all internal inconsistencies with the system ... the market process tends to achieving the dovetailing of the numerous decisions being made. The process commences with an initial absence of such consistency among decisions. The process itself is the agitation whereby decisions are rendered consistent. This agitation is the continual reshuffling of resources from one employment to another, the process does not cease so long as complete consistency had not been achieved. The key point is that the misallocation of a resource implies the existence of an unexploited opportunity for profit ... grasping of a profit opportunity amounts ... to a step in the direction of correcting such misallocation.

—Israel Kirzner (1963), *Market Theory and the Price System*: 326–327.

What is a market? There is a tendency for people to think of markets as if they are choosing entities that determine the allocation and distribution of resources. “The market,” we often hear, is responsible for the decline of certain industries, the loss of jobs, or inequality in the distribution of income, and so on. This framing neglects the reality that markets reflect the choices of individuals participating in exchange relationships with others. The market is not a place or thing and has no purpose and no ability to engage in choice. Instead, market outcomes reflect the purposes, plans, and choices of the numerous people (demanders and suppliers) who voluntarily choose to interact with others. Given this, a more accurate way to think about markets is as an array of overlapping, continually changing, voluntary interactions among people, each of whom is seeking to achieve his or her own unique goals. These interactions among individuals contribute to the emergence of a pattern of resource allocations and distributions.

Markets are valuable because in order to accomplish our various goals we typically need to coordinate with others who are also pursuing their own goals. After all, a defining feature of a wealthy society is one where people directly produce very little of what they consume. Instead, most people rely on others to produce the goods and services that they value, which they then obtain through exchange. Think about all of the goods and services that you consume on a daily basis. How many do you produce directly and without the aid of your fellow human beings? The answer for most will be none. Appreciating how much we rely on others to obtain the things we value raises a crucial question: How do we coordinate with others in an orderly manner to achieve our goals in a vastly complex world?

Chapters 3 and 4, which focused on economic calculation and the role of capital in production, provide the foundation for answering this question. In this chapter, we build on this foundation by discussing how the market process operates. Our goal is to explain the process through which the knowledge and expectations of individuals lead toward coordination and cooperation, since this is what is ultimately required for people to achieve many of their ends. This entails an understanding of how people engage in mutual discovery and learning. Those working in the Austrian tradition argue that economists should move beyond the exclusive focus on states of affairs in static equilibrium and concentrate instead upon explicating the principles underpinning the operation of the market process. These key principles are as follows:

1. markets depend on the existence of a specific set of institutions that enable the emergence of prices allowing for economic calculation;
2. economic calculation serves as a guide for the coordination of capital through time in the broader capital structure to produce value-added consumer goods;
3. markets are driven by entrepreneurial discovery in the face of sheer ignorance;
4. this process of entrepreneurial discovery occurs in an ongoing, open-ended system.

Exploring the principles

For market exchanges to occur, certain institutions must exist. Institutions are the formal and informal “rules of the game” that govern human interactions. For the operation of markets, the most important institution is a regime of property

that delineates how resources are owned and used. These property rights can be informal—shared norms about who owns what—or formal—codified legal titles for pieces of property. Property rights matter because in order to interact with others, a person must have command and control over their person and the items they wish to use and exchange. Potential trading partners must have similar command over their persons and the goods they use or offer for exchange. Absent these foundational property rights, no interaction or exchange can take place. The existence of property rights yields several broad benefits that allow markets to operate.

First, property rights allow economic actors to engage in economic calculation, which was discussed in chapter 3. Recall that economic calculation refers to the ability of choosers to determine the expected value of alternative uses of scarce resources. Property rights over the means of production allow for exchange and contestation among market participants. This process of competitive exchange leads to the emergence of market prices that capture key information about the relative scarcity of resources. Market-determined prices are crucial because they empower people to evaluate past decisions while also assisting them in planning for the future. Prices do so by capturing the specific knowledge of time and place that is known only to local actors. To understand why this is important, consider the following examples.

Assume a natural disaster adversely affects the yield of oranges. The result will be that oranges will become more scarce, relative to the situation prior to the natural disaster, which will be reflected in a higher price for oranges. The higher price communicates to people throughout the economic system that oranges have become relatively more scarce and will give them an incentive to consume fewer oranges. Alternatively, consider the discovery of a new mine for a raw material, such as iron ore. This discovery will make iron ore more plentiful, which would lead to a fall in its price. This drop in price communicates to people that iron ore is less scarce relative to the situation prior to the discovery of the new mine. People will adjust their behaviour accordingly by consuming more iron ore than they did before.

The effectiveness of prices as a means of communicating local economic conditions becomes evident when one appreciates that people throughout the economy do not have to know the underlying cause—the natural disaster or discovery of the new mine—of the price change. Nonetheless, they will adjust their behaviour accordingly to consume less, in the case of the natural disaster, or more,

in the case of the discovery of the mine, as a result of changes in scarcity conditions. In this way, market prices allow for economic actors to engage in economic calculation to coordinate the structure of capital discussed in the previous chapter.

Prices serve as a guide as people determine how scarce, heterogeneous capital should be combined with other capital in the broader capital structure. The intricate alignment of capital to produce various consumer goods is governed by price signals. These prices provide continuous feedback, as scarcity conditions change, for the revision of production plans through capital substitution and re-grouping. To return to the earlier example, the lower price of iron ore, the result of the discovery of the new mine, will make production plans that were previously unprofitable at a higher price of iron ore, more profitable. Likewise, the rise in the price of oranges as a result of the natural disaster will make certain production plans—for example, the production of orange juice—less profitable compared to what it was before the disaster. In both cases, entrepreneurs will adjust their plans and the capital structure, based on the information communicated by prices.

In addition to allowing for the emergence of market prices, property rights produce several other important benefits. Because owners have cash-flow rights—they keep any revenues associated with the use or sale of their property—they personally benefit from caring for and managing what they own. Resource owners will tend to serve as stewards of scarce resources that are valued by other people because of the potential for profit attached to doing so. Likewise, owners have an incentive to use their resources in ways that benefit others, since it is through satisfying the wants of others that resource owners earn profits. Finally, owners have an incentive to minimize the harm that their property does to others. Property rights establish a clear link between use and responsibility because owners can be held liable where their property causes harm to others. If your car does damage to my property, I can seek legal recourse against you for damages as the owner of the vehicle. The result is that clearly defined property rights lower the chance that one person's property will cause harm to another person's property since there are clear owners who can be held responsible for damages. Working in unison, the benefits associated with property rights provide both the necessary knowledge and incentive for cooperation and coordination.

Within a regime of private property rights, the market process is one of entrepreneurial discovery in the face of sheer ignorance. Entrepreneurship

involves being alert to potential profit opportunities. But these profit opportunities are not predetermined and known. To capture this point, Israel Kirzner emphasizes the difference between ignorance and sheer ignorance. Ignorance refers to a known lack of knowledge. I know that I lack the knowledge of how to construct a computer. I also know that this knowledge is available and “out there” if I ever decide to seek it out. Ignorance is an object of choice because a person could invest resources in gaining the knowledge, which they know is available, to remove their ignorance. For example, an entrepreneur might be ignorant of regulations in another geographic location because he does not currently operate in that space. If he were deciding whether to expand operations to that locale, however, he could remove his ignorance by investing additional resources to obtain the necessary regulatory information.

Sheer ignorance, in contrast, refers to unknown aspects of the world. This type of ignorance is not a result of choice and cannot be removed by investing more resources in obtaining additional information. Instead, sheer ignorance represents states of the world that are simply not known until they are discovered by entrepreneurs. But how does this discovery take place? The lure of profit is what drives entrepreneurs to be continually alert to previously unexploited opportunities and, in the process, to pull back the curtain of sheer ignorance. Because people view the world differently depending upon their subjective perceptions of their surroundings, alertness varies. This variation allows some people to identify profit opportunities that have been overlooked by others. But not all perceived profit opportunities are accurate perceptions of the underlying realities of the world.

While entrepreneurs are confident that they have identified legitimate profit opportunities (otherwise, they would not pursue these opportunities), many ventures turn out to be errors. That is, some entrepreneurs will perceive opportunities that do not, in fact, satisfy the wants of consumers. The determination of whether a perceived profit opportunity is, in fact, genuine occurs by subjecting the opportunity to the market test of profit and loss.

If the entrepreneur’s venture earns a profit, it reveals that the perceived opportunity for profit was correct. Resources were previously misallocated, allowing the entrepreneur to purchase and combine capital inputs to produce a good valued by consumers as demonstrated by their willingness to pay a price that yields a profit. A loss, in contrast, reveals that the entrepreneur’s conjecture was incorrect. He has reallocated resources in a manner that yields

less value compared to alternative uses, as demonstrated by the unwillingness of consumers to purchase the product in sufficient quantities to yield a profit. A profit signals to the entrepreneur to continue to produce while also signalling to other entrepreneurs that they can earn a profit by reallocating resources toward the profitable venture. Similarly, a loss signals to the entrepreneur that he should cease production and reallocate resources accordingly, while also communicating to other entrepreneurs that there is no profit to be had by pursuing that specific production plan.

By serving as a test of entrepreneurial conjectures, profit and loss play a key role in providing feedback to economic actors and contributes to coordination across the economic system. The profit and loss mechanism also offers a means for striking a balance between risk taking and prudence. Risk taking is desirable because it leads to innovation and betting on perceived opportunities that may benefit consumers. At the same time, undisciplined risk taking can lead to the waste of scarce resources that could instead be used to produce other, value-added goods and services. Prudence avoids excessive risk taking, but also can lead to overly cautious behaviour that may stifle the process of innovation and creative destruction, which is uncertain and thus contains an element of risk. Profit and loss help to balance these two forces.

The lure of profit provides an incentive for risk taking because a successful first mover can earn a significant profit by being the initial producer of a good valued by consumers. At the same time, the potential for loss makes entrepreneurs careful when making investment decisions. And the actual experience of earning a loss once an investment has been made will lead entrepreneurs to change their behaviours, since failing to do so will lead to further losses and eventually to complete liquidation. While the tolerance for risk varies from one person to another, an important function of markets is to balance blind risk-taking with judiciousness to ensure that scarce resources tend to be used in a manner that produces value for consumers.

The Austrian conception of the market as a discovery process stands in stark contrast to the standard model of perfect competition, which focuses on equilibrium end-states rather than on the process through which human choosers grapple with uncertainty and imperfect knowledge about future consumer demands and the best ways to satisfy those demands. The market process is continuous and involves ongoing discovery and resource reallocations

in response to those discoveries. Economic actors acquire knowledge in the process of engaging in the act of competition, as they seek to outcompete their rivals by providing a superior product at a lower price.

As F.A. Hayek put it, market competition is best understood as a discovery procedure by which people are best able to learn, correct errors, and discover new and better ways of organizing economic activity to satisfy their wants more fully. This view differs from the perfect knowledge assumption that underpins neoclassical models of markets. For Austrian economists, the central function of markets is to produce the relevant economic knowledge to coordinate human action in a world of uncertainty and constant change so that people can achieve their goals in an orderly manner.

