4. Discovery versus creation: implications of the Austrian view of the market process

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The Austrian tradition can hardly be described as a unified paradigm. The divergences between the foremost exponents are striking. Consider for instance the following controversies: Menger explicitly rejects the Böhmian theory of capital and interest; Wieser develops interventionist advice that contrasts with the liberal ideology of the whole tradition; Hayek refuses the Misesian apriorism; Lachmann and Kirzner sharply disagree on the role of the equilibrium concept in economic analysis.

Nevertheless, there seems to be a ground upon which modern Austrians (from Hayek (1937) onwards) are relatively unified: the view of the market as a process.[1]

In this chapter, we will stress in a first step that beyond this apparent agreement, there is no unity at all. Indeed, it is possible to define two distinct conceptions of the market process within the realm of the austrian tradition itself, namely the one of Hayek–Kirzner and that of Lachmann. We will in a second step investigate the origins of this divide. We will show that the cleavage lies in the exclusion of the creative dimension of the human mind from the Kirzner–Hayek conception: by contrast with Lachmann's view, agents are limited to discovery, discovery of profit opportunities and discovery of knowledge.

The distinction between discovery and creation implies much more than a mere intellectual curiosity about historical and analytical linkages between authors. More precisely, one of the issue at stake concerns the normative level: an analysis limited to discovery can attempt to prove the efficiency of unhampered markets, whereas the introduction of creation leads to the recognition of the coexistence of equilibrium and disequilibrium market forces.

2

A SYNTHETIC REPRESENTATION OF THE AUSTRIAN MARKET PROCESS

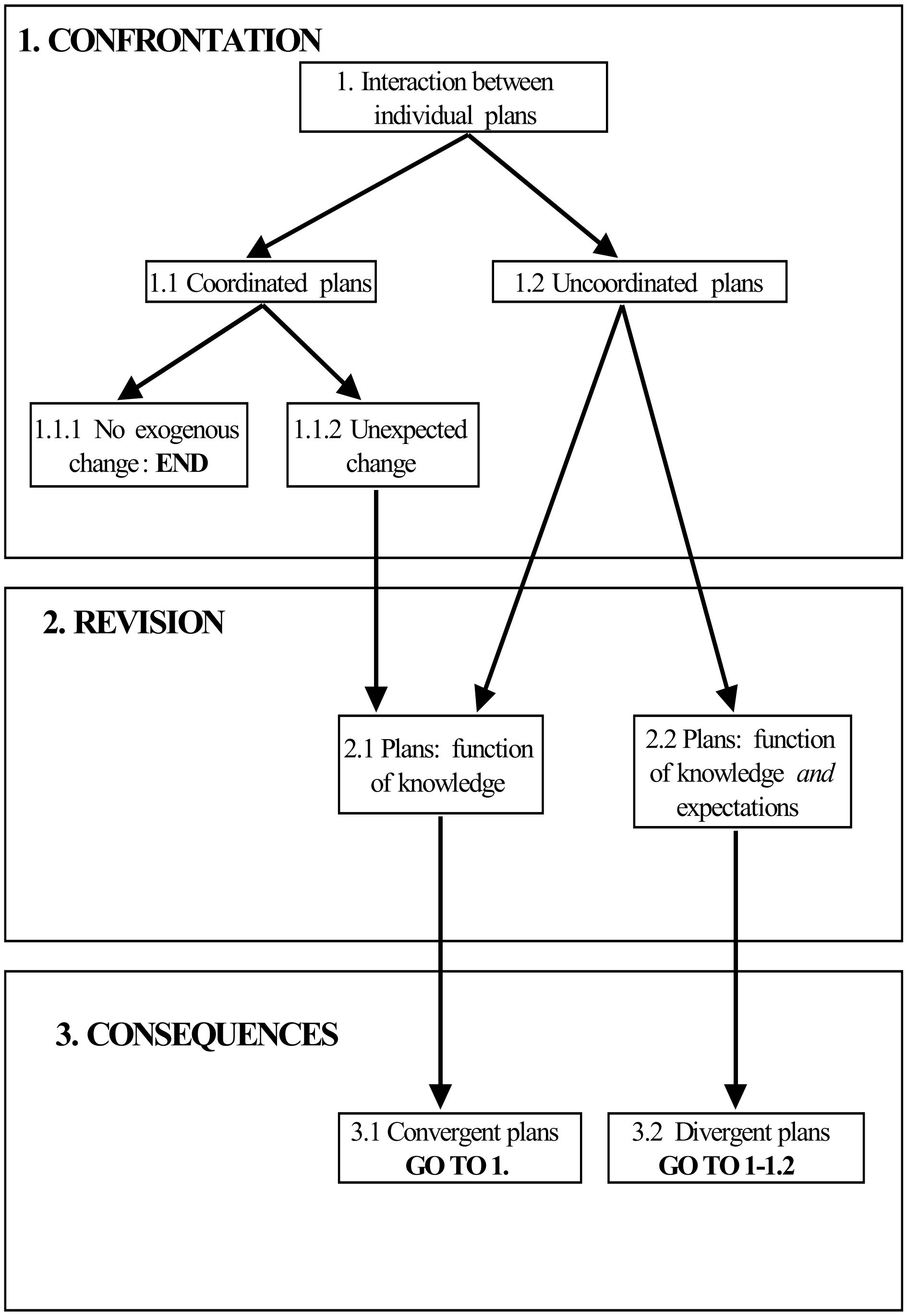
Within the Austrian logic, the market is viewed as a process; its thrust results from the interaction between individual plans. Agents are conceived as dynamic actors by contrast with the orthodox definition of *Homo Economicus*, a mere reactor to external stimuli. The market process is more precisely the outcome of the succession of three sequences:

- confrontation of individual plans: the market configuration is the result of the confrontation of the effective individual actions that took place in the past;
- revision of plans: if inconsistencies between plans occur, i.e. if plans are not well coordinated, it means that some individuals failed to reach their objectives; they will be led to modify their original plans;
- consequences of the adjustments: the interaction of the new plans leads to a new market configuration.

From this very general framework, it is possible to distinguish between three distinct views of the market process within the Austrian tradition itself: the views of Kirzner, Hayek and Lachmann. In order to delineate the specificities of each one, we propose the following conceptualisation (see Figure 5.1).

This diagram is useful for two reasons. First, it provides a synthetic overview in which it is possible to position, despite their diversity, the three authors and their conception of the market process. Second, starting from this framework, we can determine precisely what are the splitting points between the authors.

Figure 5.1 A general representation of the Austrian market process



4

THE KIRZNERIAN MARKET PROCESS

The Kirznerian view of the market process flows from the theory of entrepreneurship. Kirzner introduces a new dimension in the concept of human action inherited from Mises: entrepreneurship. Entrepreneurship expresses itself through the quality of alertness. An alert individual is able to find out unexploited profit opportunities. Profit opportunities consist in price discrepancies between sellers and buyers in a same market and reflect the imperfection of the economic configuration: in a perfectly coordinated world, all profit opportunities have been exploited and there is no room for entrepreneurship; in a disequilibrium world, discoordination is the consequence of imperfect knowledge, and imperfect knowledge is precisely the source for profit opportunities. The alert agent is not an individual possessing more knowledge than the others but an individual whose incentive is, through the existence of profit opportunities, to find out new knowledge. Entrepreneurship consists in the exploitation of the profit opportunities discovered through alertness. This category of action has an equilibrating effect on the economic configuration: entrepreneurs contribute to the diffusion of the new knowledge their alertness allows them to discover. The exploitation of a profit opportunity renders available for all agents the existence of a punctual disadjustment on the market. They can revise their plan on the basis of this new knowledge. The degree of coordination depends precisely on the amount of knowledge available to agents. From that perspective, entrepreneurship is considered to be the propeller of the adjustment toward equilibrium. The role of the entrepreneur is to reduce the initial ignorance of the economy through the discovery and diffusion of new knowledge that is revealed by the exploitation of profit opportunities.

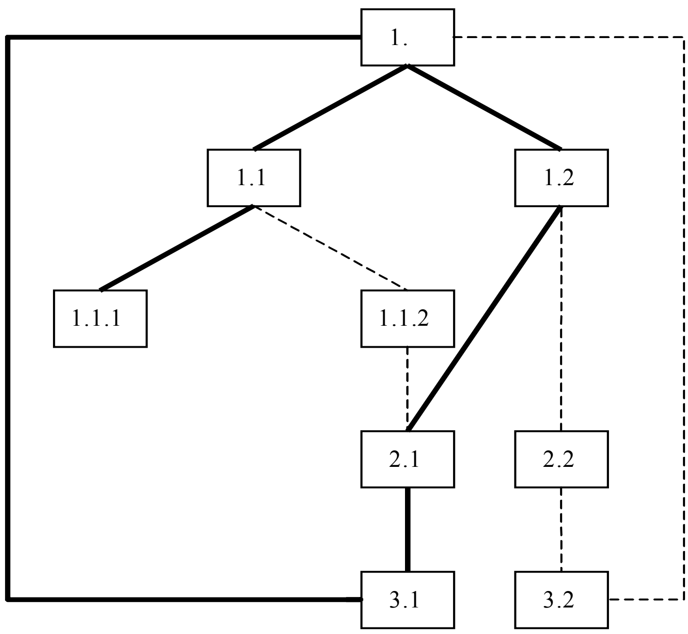
> For me the changes the entrepreneur initiates are always toward the hypothetical state of equilibrium; they are changes brought about in response to existing pattern of mistaken decisions, a pattern characterised by missed opportunities. The entrepreneur, in my view, brings into mutual adjustment those discordant elements which resulted from prior market ignorance (Kirzner, 1973, p.73).

The Kirznerian market process stemming from entrepreneurship theory is given the following conceptualisation (cf. Figure 5.2).

Suppose that the initial market configuration is one of ignorance, i.e. a situation in which individual plans are not coordinated (1.2); discoordination means existence of unexploited profit opportunities. Alert entrepreneurs notice these possibilities and take advantage from profitable arbitrages between price discrepancies on markets. This kind of action conduces to reduce ignorance in the decision–making environment (2.1).

The process converges toward equilibrium as profit opportunities are found out and exploited (3.1). The equilibrium configuration is reached when the whole set of knowledge which defines the economic configuration is made available to individuals, through entrepreneurship (1 ➔ 1.1 ➔ 1.1.1). Such an adjustment mechanism is based on the implicit assumption of the existence of an underlying reality to be discovered. Equilibrium is reached only when the set of knowledge is fully made explicit for agents; entrepreneurship is the element of change from ignorance to perfect knowledge of the data that defined the given and stable economic configuration.

Figure 5.2 The Kirznerian view on the market process



THE HAYEKIAN MARKET PROCESS

The Kirznerian conception represents a specific instance of the Hayekian market process. The specificity stems from two circumstances:

1. On the one hand, Hayek does not rely on the assumption of an immutable reality that is out–there and waiting to be discovered once for all. His world is one of continual change. Unexpected change results

from changes in exogenous variables; consequently and unlike Kirzner, Hayek sees no use in focusing '(…) on a long–term equilibrium which in an ever changing world can never be reached' (Hayek, 1946 (1949), p. 101). The set of knowledge to be discovered throught competition is not immutable and plans have to continuously adapt to this circumstance. Nevertheless, both of the authors have the same objective: to stress the efficiency of the market process, defined as a coordinating device.

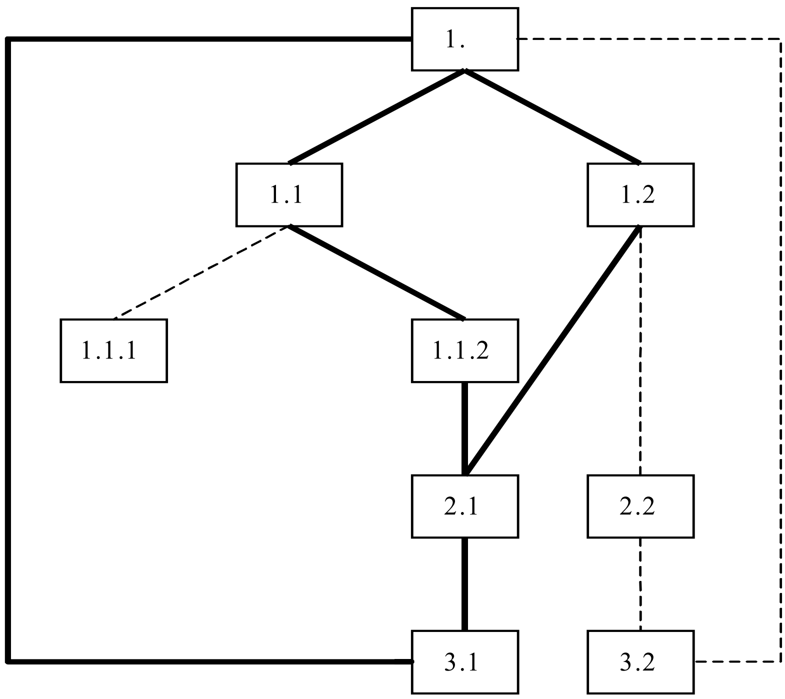
2. On the other hand, the argumentation provided by Hayek is much more general than the theory of entrepreneurship: the author develops a conception of competition as a discovery procedure. The price system resulting from individual confrontations in an unhampered market provides relevant signals for agents to adjust their plans. These prices are not equilibrium prices (in an ever changing world) but the market order is built precisely from the negative feed–backs that agents extract from them.[2] Discoordination stems from the diffuse nature of knowledge upon which agents rely to form their plan; competition, through the role of the price system, is a procedure of discovery and diffusion of knowledge and thus plays a coordinating function. According to Hayek, competition represents the most efficient procedure for knowledge discovery. This assertion is indeed a strong hypothesis. The author justifies the existence of a tendency toward equilibrium on the basis of empirical evidence:

> It is only with this assertion [the supposed existence of a tendency towards equilibrium] that economics ceases to be an exercise of pure logic and becomes an empirical science; ... In the light of our analysis of the meaning of a state of equilibrium it should be easy to say what is the real content of the assertion that a tendency towards equilibrium exists. It can hardly mean anything but that under certain conditions the knowledge and intentions of the different members of society are supposed to come more and more into agreement ... In this form the assertion of the existence of a tendency towards equilibrium is clearly an empirical proposition, that is, an assertion about what happens in the real world which ought, at least in principle, to be capable of verification. (Hayek, 1937, p. 44)

The Hayekian procedure thus unrolls as follows (cf. Figure 5.3).
In an inefficient configuration (1.2), market prices act as signposts for agents, providing new knowledge about the direction in which plans have to be modified (2.1). In that perspective, competition is by assumption an efficient device of knowledge discovery and entails the convergence of plans (3.1). The occurrence of unexpected change prevents the economy from reaching a long term equilibrium (1.1.2). Competition permits the

adaptation to the new configuration via its capacity to diffuse the new relevant knowledge (2.1 and so on...).

Figure 5.3 The Hayekian conception of the market process



THE LACHMANNIAN MARKET PROCESS

The logical founding of Lachmann's view of the market process is similar in all points but one with the Kirzner–Hayek conception. The splitting point concerns precisely the definition of individual plans. According to Hayek,

plans are conceived on the basis of the subjective interpretation of past experience. Lachmann introduces a second dimension, plans are the outcome of the interaction of two elements:

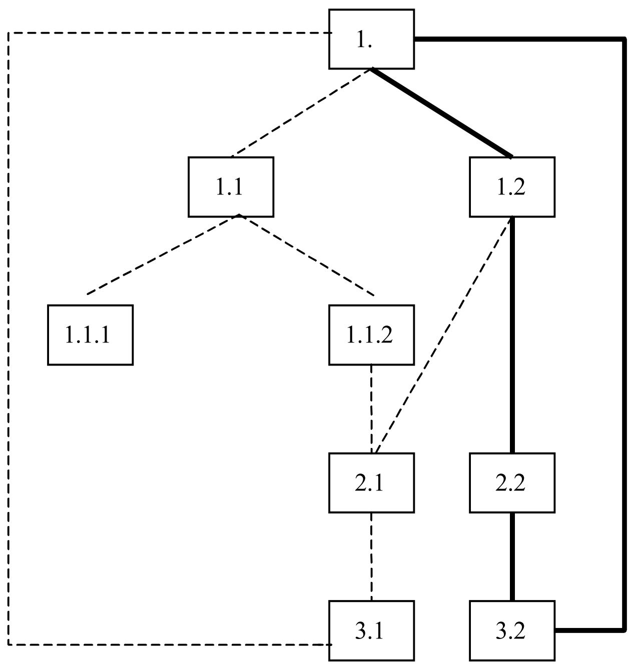
- knowledge as Hayek puts it, that is a diagnostic of the economic situation understood as interpretation of experience;

- expectations, that is an interpretation of the future situation, understood as imagination.

> ... plans are products of mental activity which is oriented no less to an imagined future than to an experienced past (Lachmann, 1969, p. 95)

Given this enlargement of the concept of plan, the resulting view of the market process sharply contrasts with the traditional one – a true butterfly effect![3] Market is described as a continuous process, characterised by unexpected change and inconsistency of plans. This later feature is the direct consequence of the introduction of subjective expectations. Plans are divergent because subjective expectations are based on the image agents form about an 'unknown though not unimaginable' future.[4] Competition could conduce to the diffusion of relevant knowledge, but good expectations cannot be diffused by any ways, for once they revealed themselves relevant they are already obsolete and need to be revised; no *ex ante* criterion of success exists. Inconsistency of plans challenges the traditional view of a tendency toward equilibrium. Market is an undetermined process governed by the interaction of equilibrium *and disequilibrium forces*.

Figure 5.4The Lachmannian view on the market process



The representation of the Lachmannian market process concerns only the right branch of our diagram (cf. Figure 5.4). Inconsistency of plans is the rule and reflects the fact that plans are built up not only from subjective knowledge but also from subjective expectations (2.2 ➔ 3.2). As a result, the economic configuration emerging from the interaction of individual plans is definitely one of discoordination (3.2 ➔ 1. ➔ 1.2). In that perspective, there is no more reason to emphasise the equilibrating function of the market. Divergence of plans is the consequence of the extension of the subjective dimension to expectations and represents, within the Lachmannian view, the propeller of change.

> The market process consists of a sequence of individual interactions, each denoting the encounter (and sometimes collision) of a number of plans, which, while coherent individually and reflecting the individual equilibrium, are incoherent as a group. The process would not go otherwise (Lachmann, 1976b, p.131).

DISCOVERY VERSUS CREATION

The cleavage between the traditional and the Lachmannian views of the market process proceeds from a different conception of the individual agent. Both lines consider the agent as an actor, in continuity with Mises' developments on human action (Mises, 1949). However, the subjective dimension of the human mind is extended to creativity within Lachmann's view, as opposed to the Hayek–Kirzner one, which limits itself to discovery. The creative agent builds plans upon his/her imagination of the future whereas the discoverer elaborates plans exclusively on the basis of the knowledge at his/her disposal. In that perspective, the degree of coordination of individual plans, that is the degree of efficiency of the market process, depends on the stock of knowledge it allows agents to discover and to use. Competition is analysed as an efficient – the most efficient – discovery procedure and the role of the entrepreneur consists in finding out unnoticed profit opportunities and diffusing the knowledge they reveal through their exploitation.

The sharp distinction between discovery and creation is never made explicit by the authors concerned. Nevertheless, no doubt that the thoroughgoing choice in the words of Hayek gives evidence to a conscious recognition of the existence of an issue ; the term 'creation' is carefully avoided. Maybe Kirzner makes it more explicit when he recognises the relevance of the critics addressed to his theory of entrepreneurship:

> My theory of entrepreneurship has sometimes been criticised as viewing the future as a kind of tapestry waiting to be unfolded: it is already there. It is simply behind the screen; it only has to be unrolled and when the future will come into the field of vision, whereas the truth surely is, the critics point out, that the future does not 'exist' in any philosophically valid sense. It must be created so that the notion of alertness in the sense of seing what is out of there in the future is a mistaken notion. I recognise the philosophical validity of this kind of criticism. (Interview in Boehm, 1992).

Beyond the conflict under analysis, the distinction between discovery and creativity appears also to contribute to a large extent to the tensions characterising the odd relationships between traditional Austrians and Schumpeter.

Consider first of all their opposition regarding the theory of the trade cycle and the role of credit: according to Hayek, economic fluctuations are initiated by the reduction of the monetary rate of interest below its natural rate, through credit creation; such a reduction is analysed as an erroneous signal provided by the banks, without real counterpart (increase in monetary savings). This signal acts as an incentive to investment for entrepreneurs. Crisis is precisely the consequence of the lengthening of the production period in a context where intertemporal preferences stay the same. In this analysis, banks appear to deteriorate the ability of free market to provide the good signals for investment. In the Schumpeter perspective, the role of credit is exactly drawn the other way round: credit represents a necessary condition for the system to evolve from one configuration to another. The impulsion of change comes from the creative behaviour of entrepreneurs who, instead of being limited to the discovery and interpretation of the relevant market signals, introduce innovations in the system: new ways of doing things and new things. Entrepreneur is a disrupter of stability and the credit system is indispensable for the viability of the transition he initiated.

This consideration leads to a second circumstance in which traditional Austrians stand in stark opposition with Schumpeter: precisely the role of the entrepreneur. According to Kirzner, the entrepreneur fills an equilibrating function through the discovery of unnoticed profit opportunities, bringing the economy from ignorance toward equilibrium, i.e. a configuration in which all profit opportunities have been discovered and where the whole stock of knowledge is available to agents. In the Schumpeterian analysis, the well–known expression of creative destruction synthesises the extent of the gap: the entrepreneur is the agent of change and disequilibrium. Creativity means the break in continuity toward a disequilibrium dynamic. The contrast between the Kirzner–Hayek view and that of Schumpeter is perfectly well drawn by Kirzner himself:

> For Schumpeter the essence of entrepreneurship is the ability to break away from routine, to destroy existing structures, to move the system away from the even, circular flow of equilibrium. For us, on the other hand, the crucial element in entrepreneurship is the ability to see unexploited opportunities whose prior existence meant that the initial evenness of the circular flow was illusory – that, far from being a state of equilibrium, it represented a situation of disequilibrium inevitably destined to be disrupted. For Schumpeter the entrepreneur is the disruptive, disequilibrating force that dislodges the market from the somnolence of equilibrium; for us the entrepreneur is the equilibrating force whose activity responds to the existing tensions and provides those corrections for which the unexploited opportunities have been crying out (Kirzner, 1973, p.127).

The Schumpeterian actor creates profit opportunities whereas the Kirznerian entrepreneur is limited to the discovery of existing opportunities.

Harking back to the present issue, a set of questions arises: why do not traditional Austrians follow Lachmann in his extension of the subjectivist dimension to expectations? Why is the Austrian theory of the trade cycle based on an implicit assumption of perfectly elastic expectations and why do not Mises and his followers deepen the implications of the speculative dimension inherent of every human action? All these questions are the symptom of the same phenomenon and call for the same answer: the rejection of the creative dimension of the human mind from the analysis.

According to us, Lachmann does not go far enough in his analysis. More precisely, he wonders why,

> Austrians fail to grasp with both hands this golden opportunity to enlarge the basis of their approach and, by and large, treated the subject [of subjective expectations] rather gingerly? (Lachmann, 1976a, p. 58).

However, the author does not come to grips with the problem. He dodges the question simply saying that at this point, there seems to be a real conundrum, or referring in his deepest argument to the strict adhesion of Mises to a neo–Kantian rationalism that impeded him from taking into account the full consequences of the very idea of time. In that perspective, Lachmann quotes Shackle, according to who 'time is the denial of the omnipotence of reason' (Shackle, 1972, p. 27); Mises deals with the dimension of time and more precisely with a Bergsonian conception of time; he therefore acknowledges the speculative aspect inherent to every human action but never went further in this recognition, for instance through the development of an analysis of the subjective nature of expectations. No reason is given for Hayek's limitation to knowledge discovery, despite the fact that the adhesion of the author to the subjectivist paradigm is by and large recognised. The following well known quotation appears numerous times in both Kirzner's and Lachmann's works:

> It is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism (Hayek, 1952, p. 31).

Why then, are traditional Austrians reluctant to extend the subjectivism of tastes and preferences to expectations? This attitude may appear curious given that their adhesion to the subjectivist paradigm is beyond doubt and the introduction of the creative dimension of the human mind through imagination seems to follow the natural course of progress described by Hayek in the foregoing quotation.

There seems to be no logical reason for this neglect. Moreover, the limitation of human action to discovery contradicts the emphasis Austrians put on time and its implications, namely uncertainty and error.

Ultimately, there seems to be only one reason that justifies such disregard. We are here referring to an ideological reason; the fact is that the introduction of imagination, i.e. of the creative dimension, would have overwhelming consequences on the representation of the market process. Consider precisely the results reached by Lachmann: we stressed above that the definition of plans in terms of knowledge − discovery dimension − and expectations − creative dimension − leads to the recognition of the influence of both equilibrating and disequilibrating forces. The existence of a tendency toward equilibrium brought about by competition and market activities is theoretically questioned; theory can do no more but describing the market as an indeterministic process, the efficiency of which (in terms of plans coordination) can no longer be established.

This result stands in sharp conflict with the normative objectives of traditional Austrians, oriented toward an unconditional defence of laisser−faire and free−market. In that perspective, Oakeshott (1962, p. 21) characterises in one expression the unifying feature of Hayek’s works: it is 'a plan to resist all planning'. This applies to the whole Austrian tradition ... except Lachmann.

The attitude of traditional Austrians toward Lachmann is rather ambivalent. This stems from the fact that the results of his analysis, quite embarrassing for anti−interventionist supporters, are built upon a deductive framework the foundations of which are the expression of the purest Austrian essence: the enlargement of the subjectivist dimension cannot be criticised for it represents an improvement in Hayek's sense, toward a deeper understanding of complex socio–economic phenomena and the introduction of expectations in the definition of plan do nothing more than making explicit Mises' assertion of the speculative dimension inherent to every human action. As a result, what is criticised is not the issue of subjective expectations, i.e. the full recognition of freedom of choice, but its logical implications, namely the view of market as a non–convergent process. More precisely, critics typically accuse Lachmann of theoretical nihilism. Traditional Austrians underline the indeterminist result of his approach: the market is the outcome of a constellation of divergent forces and this is strictly speaking all that can be theoretically deduced from the analysis.

However, such critics ignore the endeavour of the author to show that the alternative does not stand between determinism and chaos. The strict indeterminacy of market process is evidence of the limits of pure abstraction. However, the task of the theoretician does not finish at this point. The pure theory of the market process as we presented it in Figure 5.1 cannot go beyond the relatively general assertion of indeterminacy, *unless the decision–making environment is specified*. According to Lachmann, economists should aim at providing not an abstract and general theory of the market process but different theories of market processes.[5] The author refers to an ideal-typical method of analysis as it is advocated in the works of Max Weber. More precisely, the general framework of Figure 5.1 should be enriched through the specification of the institutional set–up that characterises the typical process under analysis. Our framework thus needs to be completed by a general theory of institutions. Such a theory should make the level two of our general diagram more precise. In that perspective, Lachmann's theory of institutions as he developed it in his 1970 book, is an attempt to investigate the role of institutions in the formation and revision of individual plans. Institutions, described as reference points in a world of radical uncertainty, serve as benchmarks, guides to the elaboration of plans.

> An institution provides means of orientation to a large number of actors. It enables them to coordinate their actions by means of orientation to a common signpost. ... [Institutions] enable us to rely on the actions of thousands of anonymous others about whose individual purposes and plans we can know nothing. They are nodal points of society, coordinating the actions of millions whom they relieve of the need to acquire and digest

> detailed knowledge about others and form detailed expectations about their future action (Lachmann, 1970, p. 49–50).

The theory of institutions fills a different part in Lachmann's approach of the market process compared with the Hayekian logic. Hayek's theories of cultural evolution and spontaneous order are oriented toward a different end, namely the establishment of the superior efficiency of spontaneous phenomena upon planned ones. The Hayekian theory of institutions constitutes another set of arguments for justifying the assumption of the existence of a market tendency toward equilibrium. On the contrary, Lachmann's theory of institutions constitutes more than an implicit assumption that underlines the view of the market process.

We reach here the real limit of Lachmann's developments: he lacks a general and unified theory of institutions to complete the exposition of the market process and without such a theory, his view of the market process is indeed subject to the criticism of theoretical nihilism. Nevertheless, the orientation is given and maybe could we find here the ground for a fruitful cooperation with the Institutionalist logic.

NOTES

1. Cf. Dolan (1976, ed.), especially the articles from Lachmann (1976b), ‘On the central concept of Austrian Economics: Market Process’ and Kirzner (1976), ‘Equilibrium Versus Market Process’.
2. Cf. Hayek , p. 184.
3. From now on, the term ‘traditional’, when employed to characterise an Austrian proposition, will refer to the Kirzner–Hayek view of the market process.
4. Lachmann, (1976a, p. 59).
5. Cf. Lachmann, (1986, Chapter 6).

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