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On Joseph Schumpeter and Economic Development

Working Paper No. 49

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Abstract:

In his writings Joseph Schumpeter stresses the important role played by the entrepreneur, serving as the agent bringing about change and contributing dynamic activities to an economy. Also, Schumpeter views capitalism as an evolving system, with his entrepreneur contributing to this evolution. Schumpeter also stresses the importance of innovation for enabling an entrepreneur to earn and accumulate profits. Related to innovation, Schumpeter’s entrepreneur can help bring about a “creative destruction.” This is thought to take place as outmoded businesses fail and their productive assets are bought up and creatively reorganized and brought back into production. In this manner, Schumpeter’s entrepreneur can be thought of as revitalizing the capitalistic system. Schumpeter also discusses Karl Marx as figure whose ideas assisted him in formulating his own understanding of capitalism.

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Karl Marx

This inquiry seeks to establish that in his thinking, Joseph Schumpeter emphasizes the importance of the entrepreneur and the role played by innovation in promoting economic development. In formulating his theory of economic development that includes a notion of “creative destruction”, Schumpeter relies upon the example of an intelligent entrepreneur rather than that of a greedy capitalist—a money bags—in order to illustrate the variables and mechanisms that contribute towards economic advancement. For Schumpeter, the entrepreneur engaged in “innovation” serves as the key variable contributing towards economic expansion rooted in technological change.

For Schumpeter, innovations are not simply a new business or a new commodity; rather, innovation can take many forms. Very simply, innovation involves creating new combinations of previously existing means of production. Schumpeter views capitalism as a system in constant flux, and he believes innovation contributes towards this systemic flux.

Part 1: Schumpeter’s Entrepreneur and Creative Destruction

We can gain insights into Schumpeter’s understanding of capitalism through considering two of his several books: *The Theory of Economic Development* [1911] and *Capitalism, Socialism, and Democracy* [1942]. In the former, Schumpeter explores the entrepreneur at length and places him/her at the helm,

initiating and steering the paths of development in a capitalist economy. In his second book noted, Schumpeter elaborates upon the role the entrepreneur plays in the process of what Schumpeter dubs as “creative destruction”.

In “Entrepreneurial Profit”, Chapter Four of his *The Theory of Economic Development*, the ways in which an entrepreneur contributes towards the improvement of his/her business is discussed in some detail. Entrepreneurial profit is defined as surplus over costs. Schumpeter illustrates that a producer in an economy that operates with what he notes as a circular flow, has just enough financial gain to cover his outlays, suggesting that producers just break even. Schumpeter [1911] (1934, 129) characterizes the income of these producers as “wages of management”. In other words, unless there are monopolistic tendencies, profits will tend to remain flat.

Following this explanation, the manner in which an entrepreneur can be distinguished from the producer is explained by the way an entrepreneur earns profits. Schumpeter introduces an example of a producer who has introduced a technological improvement that hastens the speed of production. Schumpeter [1911] (1934, 129-131), then states that conditions must be met in order for the entrepreneur to generate a surplus over costs. Schumpeter first emphasizes that the price of a product cannot fall so far as a result of the innovation that the improvement in production is negated. Secondly, the cost of the technology cannot

exceed the wages it would have cost to employ labor for the increased output of the good under consideration. In the case of the third condition, Schumpeter argues that an increase in productive capabilities will in turn cause the price of inputs needed in production to rise as a result of the increased demand. Schumpeter qualifies this third condition, emphasizing that the price of inputs cannot be higher for producing additional units—than before the technology was employed. If all three of these conditions are satisfied, then the entrepreneur, Schumpeter stresses that the entrepreneur will have benefit from a surplus over costs that is also greater than wages of management.

In “The Process of Creative Destruction”, the title of Chapter Seven in his *Capitalism, Socialism, and Democracy*, Schumpeter relies upon this concept of entrepreneurial profit for explaining capitalism and creative destruction. First and foremost, it is important to understand the view from which capitalism is being discussed. Schumpeter stresses that when dealing with capitalism, one is examining an evolutionary process of a system characterized by constant change. It is clear throughout the writings of Schumpeter [1942] (1950, 81-82) that he views capitalism as a system that remains in flux. In Schumpeter’s view, from within and led by the entrepreneur, capitalism goes through phases of destruction followed by restoration.

Following this understanding of capitalism, Schumpeter [1942] (1950, 83) asserts that the driving force in the aforementioned evolutionary process is the development of what is novel: namely, we find new goods for consumption, new methods of transporting or producing goods, new markets, and new forms of industrial organization. It is stated that this process—of what Schumpeter terms as creative destruction—constantly revolutionizes from within, the structures supporting the economy from within. This process of creative destruction is inextricably tied to Schumpeter's entrepreneur, who promotes these dynamic processes—as well as the consumption of goods—responding to the incentive of earning entrepreneurial profits.

Schumpeter's theories tend to integrate into the larger historical framework integral to a history of capitalism. Much of Schumpeter's discussion of creative destruction focuses on informing the reader that the current state of capitalism exists—and therefore must be examined with respect paid to economic history. It is stated that the most important aspect of competition found in the capitalist system is the competition from new commodities, new technologies, etc., for this kind of competition not only commands profits from competing firms but can rob them of the ability to exist within an industry. Schumpeter [1942] (1950, 84-85) states that even when this process of creative destruction is not appearing within a particular industry, the inevitable fact that it will revolutionize creative destruction will

indeed help to add dynamism is an ever-present possibility that creates an incentive and desire for an entrepreneur to be at the helm of economic changes and transformations.

Schumpeter uses the example of a department store versus a small retail shop in order to illustrate some effects of creative destruction. While a small shop owner may manage his/her business to the best of his/her ability, the department store—with its innovations that are new to the consumer—threatens the very foundation upon which the small shop exists. No matter how well the small business is managed, if the department store benefits from productive advantages that it is capable of selling at the price which the small shop buys, the small shop will not be able to effectively compete.

Part 2: Schumpeter's Entrepreneur and Innovation

One belief central to Schumpeter's work is the belief that the economy operates in a manner that can be described as a "circular flow". Much of Schumpeter's work expands from this belief. In his book, *The Theory of Economic Development*, Chapter One, "The Circular Flow of Economic Life as Conditioned by Given Circumstances", Schumpeter argues that the flow of the circular system is indeed closed. He roots his opinion in the idea that each person contributes to the economy exactly the amount needed to obtain what is desired to be purchased from

the economy. Furthermore, Schumpeter [1911] (1934, 9-11) states that in this book he is not attempting to describe the ways in which the economy has developed into its current form. Rather, his focus is on inquiring into the workings of the economy as an organism or mechanism that emerges at a given stage of development. Stated differently, Schumpeter sets out not to learn what specific events have caused economic development, but rather to find out what all those different and specific events have in common.

In examining the production of goods, Schumpeter classifies “labor” as the original means of production. It is then explained that goods can be classified in hierarchical order according to their relation to consumption. The first order of goods are those immediately ready for consumption, while the second order of goods must be combined with others goods in order to create a product for consumption, and so on and so forth.

Schumpeter proposes that according to this order, labor needs to be considered as a good of the highest order because labor enters at the first stage of the production process and is present in every stage of production throughout. It is then supposed by Schumpeter [1911] (1934, 16-17) that all goods can be reduced to labor and land, in the sense that other goods can be viewed as the bundles of land and labor that have been required to produce them. This exemplifies the circular flow because eventually, the first order products would be needed by the

highest order laborers that have contributed just enough to purchase what they desire, and so on and so forth.

This belief in characterizing the economy with a diagram of a circular flow is not an end-all be-all for Schumpeter. In “Fundamentals of Economic Development”, Chapter Two of his *The Theory of Economic Development*, Schumpeter states that economic development needs to be viewed as separated from the circular flow of the economy; as development is better characterized as spontaneous and also for causing a disturbance in the flow of the economy and its equilibrium. It can be observed that Schumpeter [1911] (1934, 64-65) does not believe this disturbance to originate with the consumers. Instead, he purports that innovations do not take place in a way that new wants arise first that are then met by producers. Rather, in the view of Schumpeter, the producer—or entrepreneur—initiates this economic change and educates consumers so that they desire the product that occurred by this change. This change creates a new center of equilibrium; the circular flow returns, but it could be inferred that it can be characterized by a different circle.

While consumers’ wants register as a fundamental force in the circular flow of the real economy, these wants are not the ruling variable in an economic development that implies change. Schumpeter [1911] (1934, 66-67) specifies that in discussing economic development, he is conceptualizing five distinct cases: a new good or a

new quality of a good that already existed; a new method of production; the opening of a new market in which to trade; a new supply of manufactures; or the organization of a new industry/a reorganization of an already existing industry. It is stated that these developments often displace those in the industry in which development occurs. To offer an example, air travel was likely not invented by those made wealthy in the railroad or ship travel industries. This exemplifies the discontinuity that is created by economic development. Furthermore, Schumpeter states that one must not assume the the new combinations that promote economic development were created by previously unused means of production. In other words, this development can always be assumed to be the result of different combinations of previously existing means of production.

These new combinations that can be defined as innovation are truly the harbinger of economic development. Schumpeter [1911] (1934, 61) stresses that while the entrepreneur needs to be appreciated as the face of the innovation, we must never mistake the person for the mechanism of development. Schumpeter argues that these innovations change the framework in which the economy operates. These innovations cannot be understood within the circular flow framework of the economy because they are actively changing the flow of the economic system. Schumpeter also explains that the circular flow of economics

can be understood as tending towards equilibrium; the equilibrium itself changes, but the economic system itself still tends towards some new equilibrium.

Schumpeter also draws attention to the role of credit in innovation. Credit is hailed as primarily necessary in creating the new combinations that are innovation. Schumpeter [1911] (1934, 69-71) states that the capitalistic credit system has grown by financing new combinations in all countries. It is explained that credit can be used to disconnect producers from existing productive means in order to assign those means to new combinations of production. Credit is used to outbid “old” producers in the market for the input that is to be used in a new combination. Schumpeter states that it would be an oversight to explain the importance of an innovation without explaining the role that credit often—though not always—plays in an entrepreneur accessing the productive means that were previously allotted to a different productive combination.

Part 3: Schumpeter’s Understanding of Capitalism Relative to Marx

Contributions advanced by Karl Marx undoubtedly exerted influence on Schumpeter. Schumpeter published books that deconstruct and dissect the capitalist economic system, while also exploring socialism. In “The Marxian Doctrine”, Part One of *Capitalism, Socialism, and Democracy* Schumpeter devotes multiple chapters towards delving into Marxism. “Can Capitalism Survive?, Part

II,” Schumpeter discusses capitalism relative to Marxian doctrines. Curiously, both Marx and Schumpeter support the view that indeed as a system, capitalism needs to be appreciated as a constantly changing system.

Schumpeter frequently acknowledges—in both works mentioned in this inquiry—that the view he held of capitalism as an ever-evolving entity is a perspective he gained from considering Marx’s writings. In Chapter Two, “Marx the Sociologist”, Schumpeter discusses the fact that Marx did not attempt to reduce such things as academia, art, religion, or ethics down to simply economic motives. Instead, Marx simply attempted to identify the economic conditions in which the aforementioned things have the ability to flourish.

In trying to identify this, Marx forms the theory that the conditions or forms of production are the primary determining factor in the development of societal and economic structures. The example is given that the “hand-mill” creates feudal societies and that the “steam-mill” gives way to capitalist societies. This example stresses the fact that the more advanced are the productive capabilities of a society, the more complex and competitive will be the economy in which they trade. Schumpeter [1942] (1950, 11-13) then states that insight can be gained into an economical interpretation of history by recognizing the role that social life—and within social life—the role played by social class in the sphere of production.

Schumpeter [1942] (1950, 14-15) interprets and then integrates Marx's opinions on social class into an economic perspective. He states that there are only two classes: the capitalists, and the laboring class or the proletariat. The capitalists can be characterized as the owners of means of production, including but not limited to factories, machinery and raw materials. Those forced to sell their labor in order to survive are known as members of the proletariat. It is recognized that there exist intermediate groups that both employ laborers and also perform labor services themselves. However, members of this group are treated as anomalies in the grand scheme of the capitalistic system.

Schumpeter explains that in developing his economic theory, Marx sought to understand the mechanism by which class and exchange between classes exert effects on economic systems. In Chapter Three, "Marx the Economist", it becomes clear that Schumpeter finds much value in Marx's thoughts on the matter, and he even goes so far as to state that Marx is a "very learned man" with regard to the subject. Schumpeter explains that Marx made David Ricardo's labor theory of value the basis of his inquiry in the three volumes of *Capital*. This Ricardian/Marxian value theory finds the value of a commodity proportional to the quantity of labor that the commodity contains (Schumpeter, [1942] (1950, 21-23). Although Schumpeter finds that Marx's contributions indeed offer insight into the machinations of the capitalistic system, he finds that his use of this labor theory of

value is fraught with limitations, and thus fails to serve as a useful tool in the analysis of economic systems.

Schumpeter explains his view of Marx's Theory of Exploitation. It is stated that Marx endeavored to prove that exploitation was not an accidental or occasional occurrence, but rather that it is embedded in the very logic of capitalism, itself. With this theoretical approach, Marx purports that capitalists have the ability to compel laborers to work more hours than the amount of labor required to "produce" that laborer. Schumpeter [1942] (1950, 26-27) states that this theory does not hold up to scrutiny because the labor theory of value cannot be applied to the commodity of labor itself and that assuming otherwise would be to assume that workmen are being produced according to rational cost calculations. It is asserted that in a perfectly competitive economy, gains through exploitation of labor would incentivize capitalists to expand their production, and that this expansion would lead to a rise in wages. This would suggest the ability to offset gains from exploitation. Schumpeter states that this is contradictory to the rest of Marx's work; he is explaining a mechanism by which capitalism recalibrates itself.

Even in criticism, Schumpeter acknowledges the connection between Marx's work and his own. With regard to Marx's Theory of Exploitation, Schumpeter agrees that the capitalist economy is not and cannot be a constant fixture of society for eternity. Schumpeter [1942] (1950, 31-32) recognizes and admits that Marx

understood the infinite motion of the capitalist system better than any other economist of his epoch. However, Schumpeter does not believe Marx was correct in identifying the mechanism by which capitalism is constantly changing. To Marx, capital served as the apparatus that drives economic change, and Schumpeter judges this explanation as insufficient. Schumpeter states that Marx fails to distinguish the ingenuous entrepreneur from the greedy capitalist, and that this therefore hinders his argument. In Chapter Four, “Marx the Teacher”, Schumpeter states that in the Marxian point of view, capital is only capital if it is in the hands of the distinctly capitalist class. The same exact capita—in the view of Schumpeter [1942] (1950, 45)—is not considered capital in the hands of a workman. This disconnect is pointed out as a weakness in Marx’s argument.

But in further adulation, Schumpeter delineates that Marx was the first of his time to understand the trend towards the rise of big business. However, it is explained that the Marxian economist seeks to understand economic issues with regards to class warfare or revolutions against exploitation. Using this approach, it can be understood that the Marxian syntheses would find England’s transition to free trade to be the result of proletariat dissatisfaction with the previous structural conditions of the economy. Schumpeter [1942] (1950, 47-48) warns that analysis by this method can grow weary of the class conflict and ongoing war between owners and non-owners. While Schumpeter did not agree with every single aspect

of Marx's economic theory, it is important to understand that both he and Marx are in agreement over the characterization that the capitalistic system best characterized and understood as constantly moving and evolving entity.

Conclusion

This inquiry has sought to establish that Joseph Schumpeter emphasizes the importance of the entrepreneur in driving innovation, a key source promoting economic development. Innovation occurs in countless forms; however, major innovations in any industry seem to have virtually the same effect. These innovations constantly revolutionize the flow of the current economic system. This disruption leads to a process known as creative destruction, which can be defined as the economic course by which an industry revolutionizes itself. This is stressed as an ongoing process that helps us in understanding the processes at work in economic development.

It is important to acknowledge the sources of Schumpeter's knowledge that can be found in Marx's work. Schumpeter studiously examined and considered Marx's theories, and many of his own ideas expand into the areas that he felt Marx had not justly considered. The view of the economy as a system in constant motion is a view he gained from Marx, although these two political economists hold differing opinions regarding which variables and mechanisms engender this

motion. In sum, to understand the significance of Schumpeter's contributions requires an appreciation for how he agreed with and embraced some ideas from Marx, while also challenging others.

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