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**Working Paper**

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Institute of Economic Research Working Papers, No. 104/2015

**Provided in Cooperation with:**

Institute of Economic Research (IER), Toruń (Poland)

*Suggested Citation:* Sledzik, Karol (2015) : 'Fettered' and 'unfettered' capitalism in J.A. Schumpeter's concept of Tax State and economic development, Institute of Economic Research Working Papers, No. 104/2015, Institute of Economic Research (IER), Toruń

This Version is available at:

<https://hdl.handle.net/10419/219720>

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**No. 104/2015**

**“Fettered” and “unfettered” capitalism in  
J.A. Schumpeter’s concept of Tax State and  
economic development**

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The paper submitted to

**VIII<sup>th</sup> INTERNATIONAL CONFERENCE ON APPLIED  
ECONOMICS  
CONTEMPORARY ISSUES IN ECONOMY  
*under the title*  
MARKET OR GOVERNMENT?**

Institute of Economic Research and Polish Economic Society Branch  
in Toruń

18-19 June 18-19, 2015, Toruń, Poland

**Toruń, Poland 2015**

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## **“Fettered” and “unfettered” capitalism in J.A. Schumpeter’s concept of Tax State and economic development**

**JEL Classification:** *A13, B15, K20, P7, P20*

**Keywords:** *Schumpeter, capitalism, Tax State, economic development*

**Abstract:** Economic development and transformation processes, have become much more intense in economic reality in the last years than they have ever been before. At this time has raised a lot of questions about the causes of the actual Global Crisis, future crises, the factors affecting the modern economy, about the essence of contemporary capitalism, demographic problems and overgrown bureaucracy. The most spectacular threat to capitalism, (based on private entrepreneurship) according to Schumpeter, stems from the high, growing and progressive taxation. Schumpeter saw clearly that the financing of public goods and services (requiring taxes, maybe even relatively high) is something other than a clerical control of the economic system that violates the natural economic mechanism. Moreover Schumpeter says explicitly, that entrepreneur does not have to be one person, he even states that the country (state) itself, or its agenda, can act as an entrepreneur. Therefore can be concluded that we may have to deal with “Tax State” which is typical for “fettered capitalism” and with “entrepreneurial state” which is typical for “unfettered capitalism”. The main goal of this paper is to present two different approaches to economic development concept: Schumpeter’s “fettered” and “unfettered” capitalism in the context of “Tax State” and interventionism.

### **Introduction**

Economic development and transformation processes, have become much more intense in economic reality in the last years than they have ever been

before. In the United States during and after Global Financial Crises (2007-2009) over \$16 trillion of USD was allocated to corporations and banks internationally for “financial assistance”. Recently European Central Bank (EBC) decided that it will spend 1,2 trillion of EUR to stimulate European economy. For over a year EBC will be spending 60 billion of EUR monthly because of the Euro Debt Crisis. Having regard to the deflation in Japanese and Swiss economy this appears to be not very optimistic view of the developed economies. On the other side we have BRICS countries (Brazil, Russia, India, China and South Korea) where economic processes begin to create the opportunity for sustainable development.

At this time has raised a lot of questions about boundary between state intervention and the free market capitalist economy, about the causes of the actual Global Crisis, future crises, the factors affecting the modern economy, about the essence of contemporary capitalism (probably with too much fiscalism), demographic problems of Europe and overgrown bureaucracy. Some of the answers could be found in works of Joseph Alois Schumpeter – economist who could predicted in his theories contemporary changes in economies.

Schumpeter writing one of his most recognizable book - *Capitalism, Socialism and Democracy*, claimed that by “extrapolating observable tendencies”, capitalism would eventually produce an “atmosphere of almost universal hostility to its own social order” (Schumpeter, 1943, p. 143). In this work Schumpeter presented the “transition from capitalism to socialism, where the entrepreneurial function as well as the entrepreneurial class would disappear. The large corporation, by taking over the entrepreneurial function, not only makes the entrepreneur obsolete, but also undermines the sociological and ideological functions of capitalist society”. Schumpeter also states that “there is inherent in the capitalist system a tendency towards self-destruction...[it] not only destroys its own institutional framework but it also creates the conditions for another” (Schumpeter, 1943, p. 162).

Moreover, in reference to the ills of modern economies Schumpeter’s early original article on the “*Crisis of the Tax State*” (1918) seems to be very timely. This is confirmed by the work of authors such as: Backhaus (1989, 2003), Chaloupek (2000), Hanusch (1988), Heertje (1981) or even OECD. The reason why Schumpeter wrote “*Crisis of the Tax State*” was the answer to Rudolf Goldscheid’s article on “*Staatssozialismus oder Staatskapitalismus*” (1917). However Schumpeter’s paper must be treated as a reliable element of Schumpeter’s concept of politico-economic analysis.

This paper proceeds as follows. First author presents Schumpeter’s concept of a “fettered” capitalism. Secondly was presented concept of

“unfettered” capitalism and the conclusions. In this paper author used such research methods as: a comparative analysis, analogy and deductive inference. The main goal of this paper is to present two different approaches to economic development theory: Schumpeter’s “fettered” and “unfettered” capitalism in the context of “Tax State” and interventionism.

### **“Fettered” capitalism**

Schumpeter in his historical analysis of “fallen capitalism” pointed out so-called “institutional flaws” as a threats to western economies. Pure model of capitalism (as Schumpeter called it “vital and intact or unfettered” capitalism) increasingly become more and more “fettered” capitalism. According to Schumpeter's observation, (in the twentieth century) became apparent gradual process of applying to the dynamism of capitalist development further “embarrassing shackles” in the form of various regulations. Reason for this situation was the steady overgrowth of the public sector. This phenomenon was accompanied by the constantly increasing burden of taxes.

In his study on “The Crisis of the Tax State” Schumpeter describes the transformation of the feudal power system to the capitalist system consisting of two sectors: the “free economy” and the “Tax State”. As the expenditures of the sovereign were increased by wars, administration and consumption at the court, the sovereign had to transfer rights and privileges to the guilds and merchants. The mechanism of the Tax State thus is characterized by (Backhaus, 2003, p.342):

- longterm change of the source of revenues from the disposal on natural resources and privileges to indebtedness and subsequently to taxes,
- longterm change of the social structure,
- longterm change of the political system.

Excessive growth of the public sector causes social and general-economic costs associated with conflict, which is a struggle between the public and private sector. Struggle between the intervening state (government) and defending itself against the intervention of a private entrepreneur. At this point Schumpeter draws attention to a particular part of the costs associated with this struggle. These costs relate to legal apparatus (lawyers) functioning on one side of a huge and costly legal apparatus in the service of the bureaucracy and on the other side the army of the most eminent lawyers employed by the private sphere in order to minimize the effects of public regulation. A considerable part of the total work done by lawyers goes into the struggle of business with the state and its organs. It is immaterial whether we call this vicious obstruction of the

common good or defense of the common good against vicious obstruction. But not inconsiderable is the social loss from such unproductive employment of many of the best brains. Considering how terribly rare good brains are, their shifting to other employments might be of more than infinitesimal importance (Schumpeter, 1943, p. 198).

The most spectacular threat to capitalism, (based on private entrepreneurship) stems from the high, growing and progressive taxation (Schumpeter, 1918). In his work, author shows that contemporary socio-economic system tends rapidly to a maximum tax burden on the private sphere of entrepreneurship, which leads to a weakening of economic dynamism. Schumpeter describes the transformation of the feudal power system to the capitalist system consisting of two sectors: the “free economy” (unfettered capitalism) and the Tax State (fettered capitalism).

Schumpeter's concept of the Tax State was established under the influence of Rudolph Goldscheid's *Staatssozialismus oder Staatkapitalismus* from 1917. Comparing Goldscheid's and Schumpeter's views of the state and public finance, we can conclude, that Goldscheid's concept has more dynamic character than Schumpeter's concept. Goldscheid's emphasis on the necessity of entrepreneurial initiatives carried out by the state is taken to be a realistic assumption. Schumpeter's concept instead seems to be oriented to entrepreneurial activities and innovativeness not in the state and public administration sector, but in the private sector, the “free economy” (Backhaus, 2003).

Schumpeter's approach of the Tax State applies a long-term perspective, it therefore must consider all of the drivers of the economic development as variables, and it thus has to go beyond standard economic analysis of taxes. What is needed furthermore, is the integration of new economic, political, institutional, historical and sociological aspects. Evolutionary economics and endogenic growth theory may be applied in order to analyze the long-term development of the two sectors of the economy, the “free economy” (unfettered capitalism) and the public sector. It also intensively explore the correlation of both sectors. That is why, the long-term effects of both sides of the public budget – revenues and expenditures – have to be taken into account as variables of the long-term economic development (Backhaus, 1997, p. 273).

Schumpeter wrote that “the fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates (...) it's a process of industrial mutation - if I may use that biological term - that incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative

Destruction is the essential fact about capitalism.” (Schumpeter, 1943, p. 83.). In “*Capitalism, Socialism, and Democracy*” (Schumpeter, 1943), Schumpeter recognized that the concept of dynamic capitalism was condemned to failure because the increased efficiency of the capitalist enterprise would lead to monopolistic structures and it will cause loss of the idea of entrepreneurship. This monopolistic structures nowadays may come from possible use of intellectual property protection in the form of a patent. But Schumpeter actually argued that innovation should lead to temporary monopoly, not that monopoly causes innovation in enterprise. This monopoly cannot come from intellectual property protection but from the fact that entrepreneur is an innovator whose competitive position comes from innovation implementation in economy.

This concept is also actual in nowadays mega-banks problem. The basic problems with the modern banks are mainly related with the level of concentration in the banking sector, the bonuses of the management (which are the derivative of bank’s motivational systems) but most of all are related with phenomenon that the banking sector is pursuing goals, that are harmful to the long-term economic profitability. According to Schumpeter banks should stimulate innovations implemented by entrepreneurs in the economy. Unfortunately the bankers nowadays seemed to have other priorities than those implied by their function in the economic system (Śledzik, 2014).

In one of his last works Schumpeter further highlights that it is high taxes, which are the expression and the result of decomposition of Western capitalism, are the most important premise of the transformation of capitalism into socialism (Schumpeter, 1949, p. 374). Schumpeter defines “true socialism” as a organization, which ceded control (ownership) of the means of production and production program and the right to request the income derived from the use of the means of production other than labor, to a central authority, which may be (but not necessarily) the government or parliament. Schumpeter even then pointed out the problem, that today in the era regulations introduced by the European Union, International Monetary Fund and the World Trade Organization, is essential. He saw clearly that the financing of public goods and services (requiring taxes, maybe even relatively high) is something other than a clerical control of the economic system that violates the natural economic mechanism. These statements are highly relevant today, when we witnessed boom and bust of the Credit Crunch recession of 2007-2009, and Europe's sovereign debt crises.

## **“Unfettered” capitalism**

According to any standard dictionary if you describe something as “unfettered”, you mean that it is not controlled or limited by anyone or anything. So what Schumpeter had in mind when writing “unfettered capitalism”? According to Schumpeter whereas a stationary feudal economy would still be a feudal economy, and a stationary socialist economy would still be a socialist economy, stationary capitalism is a contradiction in terms (Schumpeter 1943, p. 179). He also writes that: “... capitalist reality is first and last a process of change” (Schumpeter 1942, p. 77). The change is the essence. And this “change” is crucial for the Schumpeter’s concept of “unfettered capitalism”. In the economy “change” should come from entrepreneurship who is an innovator, and should not come from states interventionism, which causes excessive taxes and bureaucracy inhibiting innovation.

Let me note on this particular point that in the late thirties, Schumpeter began to move away from his earlier theory of entrepreneurship, then ultimately at the end of the thirties he presented “new theory”, which is completely different (Swedberg, 1991). In the *Business Cycles* (1939), Schumpeter put much greater emphasis on innovation in the strict sense, than on the entrepreneurship. The „new theory“ of entrepreneurship has been outlined by Schumpeter in four articles: *The Creative Response in Economic History* (1947), *Theoretical Problems of economic Growth* (1947), *Economic Theory and Entrepreneurial History* (1949) and *The Historical Approach to the Analysis of Business Cycles* (1949) (Clemens, 2009). This new concept was less “individualistic”. Schumpeter says explicitly, that entrepreneur does not have to be one person (which is a radical departure from his earlier recognition entrepreneur as an outstanding individualist). Schumpeter even states that the country (state) itself, or its agenda, can act as an entrepreneur. This is crucial for achieving the purpose of this paper. Therefore can be concluded that we may have to deal with “Tax State” which is typical for “fettered capitalism” and with “entrepreneurial state” which is typical for “unfettered capitalism”.

Concerning the problem of stability of the state, Schumpeter indeed pointed out that the modern state had come to existence out of a situation of fiscal need, and that a tendency towards instability in terms of a financial crisis is directly inherent to the capitalist state. Schumpeter intended to argue that a steady economic development of the two sectors may be possible, but that distinct conditions would have to be fulfilled. These conditions may concern the institutional framework, but also the organization of the enterprises and economic activities. Both sectors, the public and the private sector, must be coordinated as being complementary



to each other (Backhaus, 2003, p.345). Schumpeter has always insisted that the state (government) is naturally accompanied by capitalism and the market economy. Furthermore, it is necessary for its operation and for the stability of society and its rules. Capitalist economy cannot function without the public sphere, financed by taxation. Tax system is essential to the reproduction of capital as much as money and credit (Vecchi, 1995, p.83-84).

In 'Schumpeterian capitalism' creation, ownership and distribution of wealth were in part left up to the state (government). However, in an entrepreneurial society it is individual initiative that plays an important role in propelling the system forward. Entrepreneurial leadership is the mechanism by which new combinations are created, new markets are opened up and new technologies are commercialized that are the basis for prosperity. In an entrepreneurial society, entrepreneurship plays an essential role in the process of wealth creation and philanthropy plays a crucial role in the reconstitution of wealth (Acs, 2007, p.103). It is not the innovations that have created capitalism, but capitalism that has created the innovations needed for its existence. One could gain the opposite impression only from the fact that we know only of an economy replete with development, and here, everything takes place so fast and immediately, that we cannot always distinguish between cause and effect (Backhaus, 2003, p.71).

Furthermore, modern capitalism was perceived as an economic system that had experienced an early phase of expansion, followed by a phase of dynamic high capitalism and then transformed into a phase of an increasingly bureaucratic late capitalism, heralding the possible advent of a non-capitalist transformation (Backhaus, 2003, p.123). "The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process. (...) Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. (...) The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumer's goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. (...) Economic evolution was said to manifest itself in structural changes: the same process of industrial mutations – (...) – that instantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism" (Schumpeter 1942, p. 82-83). The future course of capitalism should remain basically undetermined, thus history would persist as an open-ended evolutionary process. It's impact cannot be predicted as it creates novel situations which would not have been possible in its absence (Schumpeter

1947, p. 150).

Another interesting issue in the Schumpeterian capitalism is the role of bank and credit in the implementation of innovation in the “capitalist free economy”. As Schumpeter says: “capitalism is that form of private property in which the innovations are carried out by means of borrowing money, which in general implies credit creation” (Schumpeter, 1939, p.223) and credit is “nothing but a means of diverting the factors of production to new uses, or of dictating a new direction to production” (Schumpeter, 1911, p.116). The banker, therefore, is not so much mainly a broker in the commodity *purchasing power* as a producer of this commodity (...) he has either replaced private capitalists or become their agent. The banker has himself become the capitalist *par excellence*. He stands between those who wish to form new combinations and the possessors of productive means. He is essentially a product of development, though only when no authority directs the social process. He makes possible the carrying out of new combinations, authorizes people, in the name of society as it were, to form them. He is the “ephor” of the exchange economy (Schumpeter, 1911, p.74). Enterprises that wish to innovate should not finance innovation with financial investment achieved from the previous production. (Schumpeter, 1934). The problem is that the modern “ephor” is not always interested in implantation of innovation in the economy. “Moreover, the fact that *seven* of the most famous banks in the world have admitted massive breaches of US sanctions designed to inhibit Iran from developing an atomic bomb, acts of treason against world security, confirms that the search for corporate banking profits is now without constraint” (Kingston, 2014).

## Conclusions

It is extremely difficult to draw the line between “fettered” and “unfettered” Capitalism. But in modern economies which are knowledge based, globalization based, internet based, innovation and technology based and tax, bureaucracy, state interventions based at the same time – the task is not as problematic any more. Tax State analysis should be based on a long-term dynamic view and should be focused on the study of the long-term development of the economic system. Schumpeter says that even states, the country (state) itself, or its agenda, can act as an entrepreneur. This is crucial for achieving the purpose of this paper. Therefore can be concluded that we may have to deal with “Tax State” which is typical for “fettered capitalism” and with “entrepreneurial state” which is typical for “unfettered capitalism”.

What is important, in the context of nowadays US and EU economic problems, is that according to Schumpeter the crisis of the Tax State is not

only understood as a financial crisis but – even more important – as a legal and political crisis. Is it not true, that in “unfettered” capitalism banks which has caused financial global crises should not bear the consequences. They should fail and should be replaced (maybe in the process of creative destruction) by new banks with money financing Schumpeterian innovations and development instead of speculation. In this connection fact, that this “financial creative destruction” was impossible to occur in US and in the EU economies, only reinforces the belief that capitalism in these economies is beginning “fettered”. This may prove that Schumpeter was right in his forecast that capitalism would sooner or later be replaced by socialism.

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