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The Age of Schumpeter

by

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## The Age of Schumpeter

1. The centenary of Schumpeter's birth coincides with a revival of Schumpeterian economics. Could the third quarter of this century justly be called the "age of Keynes" (Hicks, 1974), the fourth quarter has a fair chance of becoming the age of Schumpeter. Before giving substance to this proposition, I shall present a short introduction to Schumpeter's life, work and paradigm.
2. Schumpeter was born in a small place in Moravia as the only child of an Austrian couple. When his father, a cloth manufacturer, died four years later his mother moved to Graz where he attended the elementary school until the age of ten. Then his mother married the military commander of Vienna. For Schumpeter this meant access to Austria's foremost school which he passed with flying colors. At Vienna University (1901 - 1906) he was inspired by Böhm-Bawerk and Wieser, Carl Menger's students. After taking his doctorate in 1906 he spent the summer term in Berlin, was a research student at the London School of Economics and accepted a position at the International Court in Cairo from where he returned to Vienna to submit his habilitation thesis. Shortly afterwards (1909) he became associate professor in Czernovitz (now in the Soviet Union) and, two years later (1911) full professor in Graz, where he taught until 1919, except for 1913/14. During that year he was visiting professor at Columbia University which gave him an honorary doctor's degree at the age of 31. His last six years in Austria (1919 to 1925) were devoted to non-academic ambitions which he could not realize, neither as an Austrian Minister of Finance for less than eight months in 1919, nor as the head of a private bank which eventually collapsed in 1924, leaving him with a high personal debt to be paid off. It was with great relief that he received offers from two Universities in Japan and Germany, accepting the one from Bonn where he was Professor of Public Finance for seven years. Shortly before Hitler came to power, Schumpeter went to Harvard. He was a co-founder

of the Econometric Society, served as its President (1937 - 1941), became President of the American Economic Association (1949/50) and was designated to be the first President of the newly founded International Economic Association. Shortly after he had delivered his Presidential Address to the AEA, Schumpeter died in January 1950 in his home in Taconic/Connecticut.

3. Schumpeter's main work as a scholar has three strands: (1) an evaluation of past and current economic theory, starting with his post doctoral book on the state of economic theory (1908) and ending with the posthumous "History of Economic Analysis" (1954); (2) the elaboration of a theory of economic evolution, starting with the "Theory of Economic Development" of 1912 and culminating in his "Business Cycles" of 1939; (3) the advancement of a theory of social and institutional change, starting with the 1918 book on the "crisis of the tax state", culminating in his 1942 "Capitalism, Socialism and Democracy", and ending with his Presidential Address "The March into Socialism".
4. Obituaries and later biographic essays<sup>1</sup> allow offering a stylized picture of Schumpeter's fascinating personality<sup>2</sup>.

(1) Schumpeter was highly sensitive to aesthetic values. He always remained the aristocratic gentleman of the late Austrian Empire who loved elegant clothing, refined meals, polished manners, cultivated conversations and, above all, beautiful women. His style of writing was baroque, with frequent excursions into seductive side issues, occasionally ending up in mere l'art pour l'art. Even as an economist he seems to reveal an aesthetic bias: in his admiration for Walras and in his enthusiasm for the art of formalizing complex phenomena, an art which lay beyond his own reach.

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<sup>1</sup>Above all the seminal contribution by Haberler (1950) and the remarkable paper by Seidl (1982) who succeeds in discarding some old myths about Schumpeter through careful analysis of the historical evidence.

<sup>2</sup>For a more detailed analysis along the following lines, see Paqué(1983).

- (2) Schumpeter was a staunch individualist. He loved to "épater les bourgeois" i.e. to express shocking minority views even at the risk of isolating himself from the mainstream of political and economic thinking. Always ready to display a wide range of sparkling ideas he excited a large number of students who later became famous economists - Samuelson, Schneider, Smithies, Stackelberg, Stolper and Sweezy to mention only those whose names begin with S like Schumpeter. However, his impact was inspiration rather than indoctrination: in Schumpeter's socratic view of scholarship, there was no legitimate place for the missionary zeal and the fighting spirit of intellectual sectarianism. Furthermore, his work was too original to permit easy paradigmatic simplification: he advanced into dynamics when mainstream economics was grappling with static optimality; he stuck to microeconomics when the tide of Keynesian macrotheory supplied a new generation of economists with a fertile intellectual playground; he turned to historical methods when econometrics - under Schumpeter's own intellectual sponsorship - began to swamp economics.
- (3) In accordance with his social background Schumpeter was inclined to see the world from an elitarian perspective. He regarded clusters of talented people as the driving force behind economic and political history: entrepreneurs who push forward society's technological frontier; a nobility to protect the capitalist system by performing the political functions which are alien to the commercial outlook of the bourgeoisie; and the intellectuals who help to destroy capitalism by undermining its ethical basis in an almost tragic process of critical subversion. Even Schumpeter's unfortunate decision to enter politics in 1919 seems to have been influenced by an "elitist" belief in the historical mission of the nobility to save the monarchy<sup>1</sup>.

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<sup>1</sup> Of course, personal ambitions played their part as well. On the whole issue see Seidl (1982) p. 38.

5. More about Schumpeter's thought can be inferred from his relation to Keynes and the economics of Keynes. Apart from a streak of jealousy which may have distorted his judgement, Schumpeter's apparent dislike of Keynes' gospel had deep roots in basic differences of a paradigmatic nature. Consider his penetrating critique of the "General Theory" which focusses on four crucial points: First, it is Keynes' "practice of offering, in the garb of general scientific truth, advice which .....carries meaning only with reference to the practical exigencies of the unique historical situation of a given time and country" (1936, p.791), namely England in the 1930's, a practice which Schumpeter - then a detached observer of wordly events - regarded as appropriate for a politician, but not for a "scientific" economist. Second, it is Keynes' lighthearted use of economic aggregates, most of all "the extension of the Marshallian cross" (1936, p. 793) to aggregate demand and supply functions, a procedure which the micro-economist Schumpeter deemed to be highly suspect. Third, it is Keynes' assumption of a given technology with a lack of investment opportunities which appeared absurd to Schumpeter who had declared the dynamics of technology, the process of creative destruction, as the very essence of the capitalist system. And finally, it is Keynes' message that unemployment could be attributed to underconsumption and hence to private thrift and an unequal income distribution, a message which according to Schumpeter, enabled the disciples to destroy "the last pillar of the bourgeois argument" (1951, p. 289). To Schumpeter, the historian of intellectual and institutional change, this made up the essence of the Keynesian revolution.
6. Behind this fundamental critique lies a social vision which at least in some crucial respects is diametrically opposed to that of Keynes. This vision takes shape when we recognize how Schumpeter characterizes his great contemporary in a later essay: "He was surprisingly insular, even in philosophy, but nowhere so much as in economics" (1951, p. 274). "He was not the sort of man who would bend the full force of his mind to the individual problems of coal, textiles, steel, shipbuilding. Least of all was he the man to preach regenerative creeds

(pp. 274 f.)". In our present phase of slow growth and cumulating pains of delayed adjustment, the faith in the regenerative forces of a decentralized market system has again become critical for the choice of the appropriate socio-economic paradigm. This is sufficient justification for proposing to consider a non-Keynesian paradigm along Schumpeterian lines of thought.

7. Such a Post-Schumpeterian paradigm may be described in the following terms:

- (1) The approach is micro rather than macro, socio-economic (if not socio-ecological) rather than mechanistic. In the spirit of Schumpeter's "methodological individualism" it concentrates on processes rather than outcomes, on voluntarism rather than determinism. Being addressed to current world economic development, it stresses relevance rather than rigor, movement rather than static optimality.
- (2) Steady state equilibria may be attractive aesthetic devices, but economic life and history show cycles and discontinuities as a normal feature: sun-spot cycles, life cycles, product cycles, election cycles, fashion cycles, seasonal cycles, business cycles, growth cycles, technological revolutions and all sorts of lagged adjustments and overreactions to unanticipated events in the markets for factors and products, for assets and monies. With an unknown future, civilizations can only learn by trial and error; equilibria can only be identified by passing them from the other side, just as the pendulum finds its point of rest only in a process of damped oscillations.
- (3) What matters most in present circumstances are the driving forces of economic development. Emphasis, therefore, is on the growth and dissemination of knowledge, on pathbreaking entrepreneurs and eager imitators, on credit creation for the supply of venture capital, and on Schumpeterian competition (i.e. on innovative monopolistic competition rather than sterile perfect competition, on oligopolistic rivalry rather than collusive equilibria and on aggressive trading rather than arbitrage transactions). In the international economy,



which Schumpeter mostly neglected, emphasis is on free trade rather than fair trade (trade minus competition) and on export orientation rather than import substitution.

- (4) Elasticities, and notably adjustments involving the supply side, are primarily a function of time because of institutional and technical rigidities and inflexibilities in behavior patterns. The relevant time span is longer than the Keynesian short run (which Schumpeter equated with a forty-month cycle) but shorter than the Marxian long run (which includes the eventual breakdown of the system). In terms of calendar time, we may estimate this medium run to cover two to three decades, thus including at least one turning point of a Kondratieff cycle in Schumpeter's three-cycle-hypothesis.
- (5) In such a cyclical setting and with an unlimited growth of knowledge, stagnation can be taken as a temporary phenomenon even in the absence of new technological revolutions. It will last until relative prices of factors and goods have sufficiently adjusted to restore the incentive structure: profits and profit expectations must be high enough to induce potential entrepreneurs to overcome barriers to entry erected in favor of existing suppliers.
- (6) The real rate of interest may be zero in the model of a stationary state, as the young Schumpeter asserted; in a dynamic world it can turn out to be negative as in the recent phase of unanticipated inflation and will be correspondingly higher as it is now in the subsequent period of correction, when (1) monetary disinflation is not fully anticipated, (2) saving habits in the private and the public sector are slow to adjust to an increasing demand for loanable funds, (3) investors are slow to shift from excessive capital deepening to more capital saving (labor absorbing) technologies, or (4) investment is clouded with too much uncertainty due to a reorientation in the development process.

- (7) Uncertainty and limits to growth also result from political attempts at impairing property rights and, if intellectuals are the propelling force, from their influence on the social atmosphere, including the public's attitude towards technical progress, entrepreneurship, self-help, and Schumpeterian competition on a national and international plane. The "march into socialism", however, is not inevitable, as intellectuals in their monopolistic competition are also innovative in producing and propagating alternative models of society or learn from experience as they often do when they enter practical life or when they live under real socialism.
- (8) In an open world economy, Schumpeterian competition also prevails among governments and central banks. Such policy competition is efficient in the medium run as a process of discovery and learning although - or because - it offers unpleasant short run lessons to the misbehaving countries and central banks. In a (Keynesian) short term paradigm - so close to the heart of politicians in office - these lessons are denounced as beggar-my-neighbor policies, thus yielding popular arguments in favor of policy cartels called "coordination".
- (9) Entrepreneurial talent is in almost unlimited supply, but it often finds productive outlets only abroad, or less productive and even counterproductive use in politics and government, public and private bureaucracy or the military.
8. A Post-Schumpeterian paradigm has to cover the whole world economy with all its diversity. In accordance with the strength of the (re)generative forces we may distinguish
- (1) "advanced Schumpeterian areas" which have plenty of innovating firms and people to act as growth locomotives (e.g. Japan and the USA);

- (2) "less advanced Schumpeterian areas" which are populated by firms and people who as imitators are active absorbers of foreign technologies and capital (e.g. Taiwan, Singapore, South Korea);
- (3) "advanced Keynesian areas" which suffer from distorted factor prices depressing the marginal efficiency of capital and from institutional rigidities impeding the entry of new entrepreneurship so that government deficits and foreign demand are needed as substitutes for autonomous investment (Pre-Thatcher Britain and large parts of continental Europe);
- (4) "Less developed Keynesian economies" which for similar reasons rely on import substitution strategies, government deficits financed by inflation, and hopes for a "New International Economic Order" (e.g. Latin America and parts of Southern Europe).

This typology is, of course, not complete; we may further identify "Ricardian economies" which exploit their natural resources and convert them into consumption or other forms of wealth, "Malthusian regions" which find themselves in the population trap, and "Marxian countries" which conduct central planning and state trading.

9. The geographic base of the Post-Schumpeterian paradigm can be systematized by introducing a theory of location derived from the writings of a German economist who must be mentioned today together with Keynes, Marx, and Schumpeter, as he was born 200 years ago: Johann Heinrich von Thünen. In a book published in 1826 Thünen not only pre-discovered marginalism (which earned him high praise from Schumpeter) but also developed a center-periphery model for the spatial division of labor on a homogeneous (i.e. non-Ricardian) plane surrounded by a wilderness. Thünen took the central market as given, but the center can well be explained (1) by the provision of a public good called law enforcement or defense which is - as Adam Smith has taught us - a

prerequisite for the division of labor, or (2) by assuming a point of superior resource endowment with high quality land, raw material deposits, or favorable climatic conditions which yield a Ricardian rent, or (3) by introducing external economies of agglomeration which generate knowledge to be used by entrepreneurs and hence produce the Schumpeterian transitory rent which we call profit. In the real world we can depict many centers and a hierarchical order of them but the major center-periphery systems in the world economy have turned out to be supra-national like the Pax Britannica of the 19th century, the Pax Americana of the 20th century or the present triple center system of North America, Western Europe and Japan (leaving aside the Marxian center in Eastern Europe). As economic development essentially consists of exploiting knowledge, a social atmosphere conducive to knowledge production must be taken to be the most important element in the formation of growth centers. This is why MIT and Stanford have become the Mecca and Medina of achievement oriented thinkers and operators; why some countries like Japan and France strive hard on the technology front; and why large parts of Europe where (Keynesian) equality was considered to be more important than (Schumpeterian) excellence presently tend to fall behind in world economic development.

10. The present quarter of the 20<sup>th</sup> century is likely to become Schumpeter's age, since autonomous investment - at least in Europe - has become so weak during the last decade that the socio-political focus is shifting towards regenerative forces which have been weakened by extensive reliance on monetary-fiscal management along Keynesian lines. The medicine of boosting demand surely helped in the short run. Where it was periodically withdrawn for the sake of fighting inflation it even helped over a number of business cycles. In the medium run, however, it was bound to weaken the patient's motivations and his overall physical strength. This is so because any kind of unconditional support to suppliers - from full employment guarantees, fine tuning promises, and programs of industrial policy right down to specific subsidies and sophisticated protective devices against import competition - must be presumed

to produce a dependence effect and gradually weaken the need to adjust and with it the need that is proverbially considered to be the mother of invention and innovation. In more general terms it can be said, that permissive policies promoted the march into the soft society which, for lack of a hard constitutional dividing line between social goals and individual responsibilities, became overwhelmed by populist pressures. Moreover, permissive policies offer incentives for rent-seeking, thus distracting entrepreneurial talent from future oriented activities to lobbying and distributional issues. Eventually, governments find themselves at the limits of the tax state (which the young Schumpeter clearly foresaw).

11. The Post-Schumpeterian paradigm proposed here includes the vision of a turnaround to be brought about by regenerative forces. Where can they be found? (1) We observe disillusionment with government policies, including the welfare state; and an increasing sensitivity to fiscal issues. (2) We witness the growth of the shadow economy which has a good chance of becoming a school for entrepreneurship, similar to the black market in Europe's initial post-war phase before the miraculous reconstruction, together with a spectacular growth of self employment and job creation in new firms for new products in some parts of Europe as well as in the U.S. (3) We visualize how severe lapses from full employment are about to weaken rigid labor market institutions even in syndicalist Europe where a tendency towards greater fragmentation and flexibility has developed. (4) And we take it that further progress in telecommunications will not only boost investment by itself but also by facilitating decentralized decision making. Should these new technologies promote decentralized production, they can be expected to further improve the incentive system by making the old factory system obsolete and with it the rigid labor market institutions inherited from the past.
12. The turnaround may be firmly expected but it can come about only gradually. At least in Europe, dynamic forces are hampered by encrusted institutions. Perhaps technical progress alone will suffice to overcome institutional obstacles by carrying

innovative activities into unregulated fields. But in many regions and industries on both sides of the Atlantic, a temporary crisis may be both inevitable and necessary to bring about the destruction which Schumpeter considered to precede creation or to go along with it. By widening the spread in earnings between forward looking and backward looking persons, firms, industries, and countries, the turnaround will strain widespread feelings for equity and the so-called social-democratic consensus. And there will be no reward for tolerating inequality until the turnaround has actually led to faster growth. Rawlsians will, therefore, have to stretch their implicit time horizon beyond the Keynesian short run, so as to include the medium run which is the time horizon required for starting and successfully completing adjustment processes on the supply side. Time will remain a resource in short supply, but in high demand.

13. As an indicator of how much the time pattern of preferences diverges from the time pattern of opportunities and necessities I submit taking the dramatic change from excessively low to excessively high real rates of interest in the world economy. In my view this change reveals how much society in the past has allowed itself to live at the expense of its future. Lower real interest rates will eventually come back, albeit not by decree or a different monetary regime, and only after the world has again learned to pay its tribute to the laws of efficiency for the benefit of capital formation.
  
14. In the international context the turnaround will not get underway before a Schumpeterian perspective has gained widespread support in the industrialized and newly industrialized countries of the North. Only after more Northern entrepreneurs, firms, and governments have adopted forward looking strategies which anticipate the changing international pattern of comparative advantages, will Southern entrepreneurs, firms, and governments feel encouraged to link themselves more closely to the Northern growth locomotives. When this has happened, an accelerated world dynamics, by raising the marginal efficiency of capital in the South, will - in a virtuous circle - promote a sustainable private resource transfer to the South and

at the same time diminish the high level of uncertainty presently prevailing on international capital markets.

15. Once world economic growth has reaccelerated - say towards the end of this century - Schumpeter in his Valhalla can step back from the intellectual leadership which this essay attributes to him in the succession of Keynes. But for today the question is whether the man who wanted to be the greatest economist of his time could be imagined to agree with the preceding attempt at bringing his vision in line with the course of economic history after his death. A competent answer must be reserved to those who were lucky enough to know him personally. So I have to be quiet. There is still the wider question whether any Schumpeter-based paradigm has relevance at all for this quarter century, but here the judge must be future history itself.

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