

Economic Insights

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SCHUMPETER

In His Own Words

This article illustrates the thought process and writing of the economist who probably best understood capitalism and its evolutionary development. Joseph Schumpeter is remembered today for his concept of capitalism's tendency for "creative destruction." But as Mike Cox demonstrates with this collection of quotes, Schumpeter's writings tackled a number of complex topics, many of which remain controversial.

Schumpeter was not an idle theorist who wrote solely for his fellow economists. Rather, he was one of the last grandly knowledgeable—and profoundly insightful—social theorists of the 20th century. And one certainly can't claim to understand capitalism without having been introduced to Schumpeter's keen observations about the market process and ideas about its probable future evolutionary path. We hope this introduction to his work will not only enlighten you but perhaps also inspire you to seek out his many important contributions to economics. It will be time well spent.

— **Bob McTeer**
President
Federal Reserve Bank of Dallas

Born in Czechoslovakia in 1883, economist Joseph Schumpeter was far ahead of his time. More clearly than any other economist past or present, Schumpeter understood and articulated the dynamics of the capitalist economic process. Although perhaps best known for his theory of "creative destruction," Schumpeter also offered many valuable insights into other areas of economics: innovation, economic growth, business cycles, unemployment, saving, income distribution, monopoly, political economy and more. Only in the past two decades or so, as economists back away from the teachings of John Maynard Keynes and face the failure of macroeconomic theory to adequately explain economic growth, has Schumpeter's genius received due recognition.

Schumpeter graduated from the University of Vienna in 1904, began teaching in 1909 at the University of Czernowitz and then moved to the University of Graz in Austria. He first visited the United States in 1924, returning to Europe in 1925 as a professor at the University of Bonn. With Hitler's rise in 1932, Schumpeter left Europe to take a position at Harvard University, where he remained until his death in 1950. He was a founding member of the Econometric Society in 1930 and later served as its president. He was also president of the American Economic Association in 1948.

Schumpeter was prolific, with 21 books and pamphlets, 127 articles and numerous other works to his name. He is best known for his book *Capitalism, Socialism, and Democracy*, published

in 1942. All totaled, he penned more than 8,400 pages of insightful reading. No review short of a tome could possibly give adequate credit to his life's work. And thus the following sampling of quotes should be viewed as merely this author's favorites, cut twice by half to fit the space constraints of this publication.

Capitalism

Capitalism is an economic system based on private property rights, pursuit of self-interest, freedom to choose and ability to borrow. It is a method of economic *change* guided by individual needs and wants and financed by credit (obtained through debt and equity). Far from the popular image of a haven for "corporate fat cats," a capitalist economy crowns the consumer as king, and the system provides for the well-being of the masses.

We have to define that word which good economists always try to avoid: capitalism is that form of private property economy in which innovations are carried out by means of borrowed money. *BC*, 223.

We must always start from the satisfaction of wants, since they are the end of all production. *TED*, 65.

Consumers' satisfaction supplies the social meaning for all [capitalist] economic activity. *BC*, 73.

The fundamental impulse that sets and keeps the capitalist engine in

Capitalism

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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. *CSD, 83.*

These spontaneous and discontinuous changes...appear in the sphere of industrial and commercial life, not in the sphere of the wants of the consumers....Assume tastes as “given.” *TED, 65.*

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same 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. It is what capitalism consists in and what every capitalist concern has got to live in [Schumpeter's emphasis]. *CSD, 83.*

Capitalism...is by nature a form or method of economic change and not only never is but never can be stationary. *CSD, 82.*

[Capitalism is]...the perennial gale of creative destruction. *CSD, 84.*

Economic Growth

Economies don't grow, they evolve. The dictionary defines growth as an increase in quantity or size. If an economy were to literally grow, it would have more or bigger companies hiring more of the same kinds of workers and producing more of the same goods and services. Evolution, in contrast, is a process of continuous change, leading to a higher, more complex and better state. Capitalist economies evolve, and their evolution is endogenous, arising spontaneously from the ingredients of the capitalist economic system. The competition to innovate (so as to gain market share or simply survive) pushes living standards forever onward and upward like a perpetual-motion machine. Moreover, there is no reason to believe that progress will slow over time; indeed, it may even speed up as new technologies spill over into other

areas, making whole new industries possible or economically feasible. Technology spillovers—unintended consequences—are the alchemy of the capitalist macroeconomic system. Doom-saying in the capitalist economy is a losing proposition.

The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process. *CSD, 82.*

The changes in the economic process brought about by innovation, together with all their effects, and the response to them by the economic system, we shall designate by the term Economic Evolution. *BC, 86.*


Economists are at long last emerging from the stage in which price competition was all they saw....In capitalist reality...it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization...competition which...strikes...existing firms...at their foundations and their very lives. This kind of competition is...much more effective than the other...and [is]...the powerful lever that in the long run expands output. *CSD, 84–85.*

Whenever...a given quantity of output costs less to produce than...before, we may be sure, if prices have not fallen, that there has been innovation somewhere. It need not necessarily have occurred in the industry under observation, which may only be applying, or benefitting from, an innovation that has occurred in another. *BC, 88–89, footnote 1.*

We are just now in the downgrade of a wave of enterprise that created the electrical power plant, the electrical industry, the electrified farm and home and the motorcar. We find all that very marvelous, [yet]...we cannot

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for our lives see where opportunities of comparable importance are to come from. As a matter of fact, however...the mere utilization of the achievement of the age of electricity...would suffice to provide investment opportunities for quite a time to come. *CSD, 117–18.*

Those writers [Thomas Malthus, James Mill, David Ricardo] lived at the threshold of the most spectacular economic developments ever witnessed. Vast possibilities matured into realities under their very eyes. Nevertheless, they saw nothing but cramped economies, struggling with ever-decreasing success for their daily bread. They were convinced that technological improvement...would... fail to counteract the fateful law of decreasing returns...and that a stationary state of the economic process was near at hand. *HEA, 571.*

Most of us seem here to commit a mistake in handling the concept of decreasing returns....It applies to given production functions and generally stationary conditions.... [However, as] a law of decreasing returns from successive innovations...the statement is entirely unwarranted....The world of possible innovation cannot be mapped out. *BC, 499–500.*

Technological possibilities are an uncharted sea. We may survey a geographical region and appraise... that the best plots are first taken into cultivation, after them the next best ones and so on. At any given time during this process it is only relatively inferior plots that remain to be exploited in the future. But we cannot reason in this fashion about the future possibilities of technological advance. From the fact that some of them have been exploited before others, it cannot be inferred that the former were more productive than the latter. And those that are still in the

lap of the gods may be more or less productive than any that have thus far come within our range of observation....There is no reason to expect slackening of the rate of output through exhaustion of technological possibilities. *CSD, 118.*

Innovation and the Business Cycle

Competition drives innovation, and innovation drives progress, but not without a corresponding economic churn—out with the old and in with the new. Schumpeter certainly understood that progress, by nature, is unsettling, but he likely would have laughed at the adage “I’m in favor of progress; it’s all the changes I don’t like.” He saw innovation as the root cause of most business cycles yet not a cause for grieving—even during recession—since it is through economic churn that the interests of the consumer are ultimately served. Technological innovation sometimes causes a long wave of economic activity—a tsunami—during which normal waves all but disappear.

Innovation is the outstanding fact in the economic history of capitalist society or in what is purely economic in that history, and also it is largely responsible for most of what we would at first sight attribute to other factors. *BC, 86.*

Surely, nothing can be more plain or even more trite common sense than the proposition that innovation...is at the center of practically all the

phenomena, difficulties, and problems of economic life in capitalist society. *BC, 87.*

Individual innovations imply, by virtue of their nature, a “big” step and a “big” change. A railroad through new country, i.e., country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any “ways of doing things” which have been optimal before remain so afterward. *BC, 101.*

It is by no means farfetched or paradoxical to say that “progress” unstabilizes the economic world, or that it is by virtue of its mechanism *a cyclical process* [Schumpeter’s emphasis]. *BC, 138.*

It is, after all, only common sense to realize that, but for the fact that economic life is in a process of incessant internal change, the business cycle, as we know it, would not exist. *BC, 138.*

All we can thus far say about the duration of the units of [the business cycle] and of each of [its] two phases is that it will depend on the nature of the **particular innovations that carry a given cycle** [Emphasis added]. *BC, 143.*

These revolutions periodically reshape the existing structure of industry by introducing new methods of

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production—the mechanized factory, the electrified factory, chemical synthesis and the like; new commodities, such as railroad service, motorcars, electrical appliances; new forms of organization. *CSD*, 68.

Those revolutions are not strictly incessant; they occur in discrete rushes which are separated from each other by spans of comparative quiet. The process as a whole works incessantly however, in the sense that there always is either revolution or absorption of the results of revolution, both together forming what are known as business cycles. *CSD*, 83, footnote 2.

Our model...does not give to prosperity and recession...the welfare connotations which public opinion [typically] attaches to them. Commonly, prosperity is associated with social well-being, and recession with a falling standard of life. In our picture they are not, and there is even an implication to the contrary. *BC*, 142.

Times of innovation...are times of effort and sacrifice, of work for the future, while the harvest comes after...The harvest is gathered under recessive symptoms and with more anxiety than rejoicing....[During] recession...much dead wood disappears. *BC*, 143.

If we glance at those long waves in economic activity, analysis...reveals the nature and mechanism of the capitalist process better than any-

thing else. Each of them consists of an “industrial revolution” and the absorption of its effects. *CSD*, 67.

The Firm, Innovation and Profit

Firms—particularly new ones—are the means by which innovation enters the economy. Firms have a life cycle that begins with the introduction of a new, better or cheaper product and ends likewise (with a competitor’s introduction elsewhere). Firms tend to be the most profitable when young, before competitors have had the time to enter the market with a cheaper, better alternative. Economic development flows from innovation, and innovation requires anticipated profit, but profit sows the seeds of its own demise by beckoning other suppliers (even outright copiers). Patent laws, in this regard, can help to preserve profit and thus stimulate innovation. But over the long term, the law of the corporate jungle is clear: mutate or die.

Most new firms are founded with an idea and for a definite purpose. The life goes out of them when that idea or purpose has been fulfilled or has become obsolete or even if, without having become obsolete, it has ceased to be new. That is the fundamental reason why firms do not exist forever. Many of them are, of course, failures from the start. Like human beings, firms are constantly being born that cannot live. Others may meet...death from accident or illness. Still others die a “natural” death, as men die of old age. And the “natural” cause, in the case of firms, is pre-

cisely their inability to keep up the pace in innovating which they themselves had been instrumental in setting in the time of their vigor. *BC*, 94–95.

It is not the owner of stage-coaches who builds railways. *TED*, 66.

Profit...is the premium put upon successful innovation in capitalist society and is temporary by nature: it will vanish in the subsequent process of competition and adaptation. *BC*, 105.

That is why, as Adam Smith observed, new industries are as a rule more profitable than old ones. *BC*, 95, footnote 2.

Practically every enterprise [is] threatened and put on the defensive as soon as it comes into existence. *BC*, 107.

For profits to emerge it is essential that the “suicidal stimulus of profits” should not act instantaneously. *BC*, 105.

Without development there is no profit, without profit no development. *TED*, 154.

Patent legislation is one of the few instances of legal recognition of the social functions of profit in capitalist society. *BC*, 107, footnote 1.

Saving

You can’t save your way to wealth—either personally or as a nation. True wealth accrues mainly through innovation. Individual fortunes are built that way, as is the commonwealth.

The classical writers...clearly perceived, though they may have exaggerated, the role of saving and accumulation [as]...they linked saving to the rate of “progress.” *CSD*, 76.

Savings is obviously an important factor in explaining the course of

The Firm, Innovation and Profit

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economic history through the centuries, but it is completely overshadowed by the fact that development consists primarily in employing existing resources in a different way.... Different methods of employment, and not saving...have changed the face of the economic world in the last fifty years. *TED, 68.*

The bulk of private fortunes is, in capitalist society,...the result of the process of which innovation is the "prime mover."...Saving, consistently carried on through generations, could not have been nearly so successful as it was if there had not been surpluses, due to innovation, from which to save. *BC, 106.*

Monopoly

Firms bring new goods to market precisely with the hope that they can attain some noncompetitive advantage—say, a monopoly—and exploit what they create for profit. Laws that seek to immediately destroy monopoly, therefore, will slow progress. Private monopolies (though not public ones) tend to be short-lived as the capitalist economy is constantly searching for better ways to satisfy people's wants and needs. The more oppressive the monopoly, the quicker it summons its own death by inviting a new and better product.

Enterprise would in most cases be impossible if it were not known from the outset that exceptionally favorable situations are likely to arise which if exploited by price, quality and quantity manipulation will produce profits adequate to tide over exceptionally unfavorable situations. *CSD, 89–90.*

[Large profits are] the baits that lure capital on to untried trails. Their presence explains in part how it is possible for so large a section of the capitalist world to work for nothing: in the midst of the prosperous twenties just about half of the business corpo-

rations in the United States were run at a loss, at zero profits, or at profits which, if they had been foreseen, would have been inadequate to call forth the effort and expenditure involved. *CSD, 90.*

There is no general case for indiscriminate "trust-busting" or for the prosecution of everything that qualifies as a restraint of trade. Rational as distinguished from vindictive regulation by public authority turns out to be an extremely delicate problem which not every government agency, particularly when in full cry against big business, can be trusted to solve. *CSD, 91.*

Pure cases of long-run monopoly must be of the rarest occurrence [because]...the power to exploit at pleasure a given pattern of demand ...can under the conditions of intact capitalism hardly persist for a period long enough to matter. *CSD, 99.*

Why then all this talk about monopoly?...Economists, government agents,

Monopoly

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journalists, and politicians in this country obviously love the word because it...is sure to rouse the public's hostility. *CSD, 99–100.*

Credit and Capital

The capitalist engine runs on credit. Every new venture requires funding—either through borrowing (debt) or ownership (equity)—because the people with new ideas (the innovators) and those best able to market them (the entrepreneurs) aren't generally those who are flush with cash (the capitalists). Without credit, the economic system would yield as little fruit as were there no new ideas or people to sell them. Strong new firms choke out old weak ones, in part, by raising the cost of credit everywhere.

Capitalism is that form of private property economy in which innovations are carried out by means of borrowed money...[that is,] credit creation....Most of the features...of capitalism would be absent from the economic and...cultural process of a society without credit creation....

Credit and Capital

For actions which consist in carrying out innovations we reserve the term Enterprise; the individuals who carry them out we call Entrepreneurs.

Living Standards of the Masses and the Distribution of Income

The capitalist engine is first and last an engine of mass production which unavoidably means also production for the masses.

Therefore, we shall date capitalism as far back as the element of credit creation. *BC, 223–24.*

Credit creation [is] the monetary complement of innovation. This relation ...is at the bottom of all the problems of money and credit. *BC, 111.*

The carrying into effect of an innovation involves, not primarily an increase in existing factors of production, but the shifting of existing factors from old to new uses....If innovation is financed by credit creation, the shifting of the factors is effected not by the withdrawal of funds—“canceling the old order”—from the old firms, but by the reduction of the purchasing power of existing funds which are left with the old firms while newly created funds are put at the disposal of entrepreneurs: the new “order to the factors” comes, as it were, on top of the old one, which is not thereby canceled. *BC, 111–12.*

For actions which consist in carrying out innovations we reserve the term

Enterprise; the individuals who carry them out we call Entrepreneurs. *BC, 102.*

The entrepreneur may, but need not, be the “inventor” of the good or process he introduces. Also, the entrepreneur may, but need not, be the person who furnishes the capital. *BC, 103.*

Risk bearing is no part of the entrepreneurial function. It is the capitalist who bears the risk. The entrepreneur does so only to the extent...he loses other people’s money. *BC, 104.*

The only realistic definition of stockholders is that they are the creditors (capitalists) who forego part of the legal protection usually extended to creditors, in exchange for the right to participate in profits. *BC, 104.*

Living Standards of the Masses and the Distribution of Income

Capitalism’s greatest accomplishment is that it progressively raises the living standards of the masses. Nobody ever got rich selling just to the rich. To

prosper under capitalism, you must make your product affordable to the masses—get rich raising the general welfare. The opportunity to prosper is itself open to the general masses, making upward income mobility and a fluid income distribution the norm of the capitalist system.

The capitalist process, not by coincidence but by virtue of its mechanism, progressively raises the standard of life of the masses. It does so through a sequence of vicissitudes, the severity of which is proportional to the speed of the advance. But it does so effectively. One problem after another of the supply of commodities to the masses has been successfully solved by being brought within the reach of the methods of capitalist production. *CSD, 68.*

The capitalist engine is first and last an engine of mass production which unavoidably means also production for the masses. *CSD, 67.*

Electric lighting is no great boon to anyone who has money enough to buy a sufficient number of candles and to pay servants to attend them. It is the cheap cloth, the cheap cotton and rayon fabric, boots, motorcars and so on that are the typical achievements of capitalist production, and not as a rule improvements that would mean much to a rich man. Queen Elizabeth owned silk stockings. The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily decreasing amounts of effort. *CSD, 67.*

The water-tight division between people who (together with their descendants) are supposed to be capitalists once for all and others who... are supposed to be proletarians once for all is not only...utterly unrealistic

Employment, Unemployment, Jobs and Labor

I do not think that unemployment is among those evils which, like poverty, capitalist evolution could ever eliminate of itself. I also do not think that there is any tendency for the unemployment percentage to increase in the long run.

but it misses the salient point about social classes—the incessant rise and fall of individual families into and out of the upper strata. *CSD*, 18.

Employment, Unemployment, Jobs and Labor

Most layoffs stem not from the failure of the worker or the firm or the capitalist economic system, but—to the contrary—owe to the success of someone somewhere else who has invented a new, better or cheaper product and, in doing so, lessened the demand for existing ones. Still, labor will never see it that way and will seek laws designed to protect existing jobs or provide for unemployment. Only through allowing capitalism's creative destruction to work unfettered can society fully enjoy the higher levels of consumption, shorter work week and better working conditions that the mechanism brings.

It is obvious...that in the case of replacement of a carriage by motorcar, the coachman will be technologically unemployed...in the narrow sense, although no machine drives his horses henceforth, or that it does not make any difference whether a bookkeeping clerk becomes unemployed because of the introduction of a calculating machine or another rationalizing device, or whether a cotton picker becomes unemployed because of the introduction of a cotton-picking machine or because cotton is being eliminated by the competition of the standard fiber. *BC*, 514–15.

Technological Unemployment. This term...cover[s]...displacement of workmen by machinery...[and by] industries that introduce new production functions. Questionnaires devised to find out from workmen reasons for their dismissal can, therefore, never bring out the phenomenon we mean and will always yield results that understate it. *BC*, 514.

Only in a minority of cases will workmen be able to recognize the technological change responsible for their dismissal. For this it would be necessary that machines be introduced in an existent plant under the eyes of the workmen and that dismissal be effected immediately after. *BC*, 514, footnote 1.

I do not think that unemployment is among those evils which, like poverty, capitalist evolution could ever eliminate of itself. I also do not think that there is any tendency for the unemployment percentage to increase in the long run. *CSD*, 69.

But whether lasting or temporary, getting worse or not, unemployment undoubtedly is and always has been a scourge....The real tragedy is not unemployment *per se*, but unemployment plus the impossibility of providing adequately for the unemployed *without impairing the conditions of further economic development* [Schumpeter's emphasis]. *CSD*, 70.

Finally, we should take account of variations in the amount of voluntary leisure, which...undoubtedly often is one form of taking increased real income....In this sense the reduction of working hours is one of the most significant "products" of economic evolution. *BC*, 497–98.

Capitalism's Greatest Enemy: The Intellectual

The proper role of a healthily functioning economy is to destroy jobs and

put labor to better use elsewhere. Despite this simple truth, layoffs and firings will still always sting, as if the invisible hand of free enterprise has slapped workers in the face. Unsettling by nature, capitalism's churn gives rise to a labor movement designed to protect workers from job loss. That movement is fed emotionally by displaced workers and others who blame the capitalist system for their troubles, but it is led psychologically by a whole other type of person—the intellectual. Intellectuals—with little to do owing to the success of the capitalist economic system but with an intense desire to be seen as caretakers of society's general well-being—anooint themselves as leaders of the labor movement. They object to capitalism on moralistic grounds and seek its destruction and replacement by another system—socialism—which places them center stage.

I felt it my duty...to inflict upon the reader...my paradoxical conclusion: capitalism is being killed by its achievements. *CSD*, xiv.

Capitalism inevitably...educates and subsidizes a vested interest in social unrest. *CSD*, 146.

One of the most important features of the later stages of capitalist civilization is the vigorous expansion of the educational apparatus and particularly of the facilities for higher education. *CSD*, 152.

The man who has gone through a college or university easily becomes

Capitalism's Greatest Enemy: The Intellectual

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psychically unemployable in manual occupations without necessarily acquiring employability in, say, professional work. *CSD*, 152.

All those who are unemployed or unsatisfactorily employed or unemployable drift into the vocations in which standards are least definite....They swell the host of intellectuals...whose numbers hence increase disproportionately. They enter it in a thoroughly discontented frame of mind. Discontent breeds resentment....righteous indignation about the wrongs of capitalism. *CSD*, 153.

The hostility of the intellectual group—amounting to moral disapproval of the capitalist order—is one thing, and the general hostile atmosphere which surrounds the capitalist engine is another thing. *CSD*, 153.

Capitalist evolution produces a labor movement which obviously is not the creation of the intellectual group. But it is not surprising that such an opportunity and the intellectual demerger should find each other. Labor never craved intellectual leadership but intellectuals invaded labor politics. They had an important contribution to make: they verbalized the movement, supplied theories and slogans for it—class war is an excellent example—made it conscious of itself....They naturally radicalized it, eventually imparting a revolutionary bias to the most bourgeois trade-union practices....Having no genuine authority and feeling always in danger of being unceremoniously told to mind his own business...[the intellectual] must flatter, promise and incite, nurse left wings...appeal to fringe ends....Thus, though intellectuals have not created the labor movement, they have yet worked it up into something that differs substantially from what it would be without them....[This]...explains why public

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policy grows more and more hostile to capitalist interests. Intellectuals rarely enter professional politics and still more rarely conquer responsible office. But they staff political bureaus, write party pamphlets and speeches, act as secretaries and advisers, make the...politician's...reputation....In doing these things they...impress their mentality on almost everything that is being done. *CSD*, 153–54.

Capitalism stands its trial before judges who have the sentence of death in their pockets....The only successful victorious defense can possibly produce is a change in the indictment. *CSD*, 144.

Schumpeter's prognosis of the death of capitalism has not been borne out, perhaps in part because of his brilliant exposure of capitalism's enemies and the treachery they plot. Herein lie both the paradox and the promise. We must remember that Schumpeter was himself an intellectual, who surely enjoyed winning intellectual battles. No doubt he sought to defeat socialism's most formidable intellectual, Karl Marx. But having fled Europe in 1932 upon the rise of Hitler's totalitarian state, Schumpeter took up berth in Harvard's department of economics and once again, paradoxically, found himself immersed in a sea of anticapitalists: university professors.

The chronology of Schumpeter's

writing as it intertwines with his life experience says much. We must not ignore the fact that it was in 1942—following a decade at Harvard—that Schumpeter proffered (in *Capitalism, Socialism, and Democracy*) his trenchant indictment of the intellectual establishment whose swell he saw as the greatest threat to capitalism's future. Like a prophet who alters the course of history by revealing its possible future path, Schumpeter perhaps even sought to fight and win the intellectual battle with capitalism's enemies yet unborn. ■

—W. Michael Cox
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and Chief Economist

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